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Contractor's Survival Manual

Revised Edition

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Revised by

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To Dianne, who said, "You're going to write a what?" But typed the manuscript anyway. Thanks 123 still

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Contents

PART ONE:

SURVIVING

Which Way Is Up?

You picked up this book because you've got a problem and you need help. Good. That's why I wrote this book. You'll find how-to titles for construction contractors in almost any good bookstore. But you're not going to find another book like this — what it takes to survive in the construction industry, in both good times and bad.

Survival is the operative word. Many contractors don't. They try construction contracting for a while and then give up, owing too much money, taking on too much work, making too little profit and struggling with too many problems. That's too bad. Those who left the construction industry in the early 1990s missed out on the prosperity construction pros enjoyed in the decade that followed. More than a few fortunes were made during those good years. I know because I was there and watched it happen. I've been in the business since the 1960s as a contractor, architect and real estate developer. I've kept my head above water (nearly always) and completed projects that gave me real satisfaction. I've also had some close calls and made my share of mistakes. That happens to every construction company. Some of the most successful have been on the brink of bankruptcy several times. But they survived — for reasons I'll cover in the next 14 chapters.

If you're in a financial bind right now or can't see your way out of the current mess, relax. I've been there too, and have been able to work my way back to prosperity. You can do the same. This book explains how.

Most construction problems begin with a dollar sign. With enough cash you can get through nearly any crisis. But most of us have limited resources. So that's my starting point. You've got only so much cash and nearly all is committed to meet current obligations. If that's not your situation, if you've got seven figures sitting in a checking account, congratulations! You don't need this book. Put it down and go on to something else. This reference is for those of us who go to the financial brink on nearly every project.

"Expect problems. Stay on track. Stay focused. Ignore distractions..."

Is there hope? Yes, if you're willing to work at it. Nothing breeds success better than hard work and attention to detail. Expect problems. They're going to happen. It's what you do to overcome problems that matters. I can't teach you perseverance. But I highly recommend it. Stay on track. Stay focused. Ignore distractions (like threats from creditors). Keep working on what really matters.

Developing a workable way out of trouble is what I call "discovering which way is up." An entire chapter is devoted to this "discovery." On the way up, you'll upset a few clients, suppliers, business acquaintances, lenders, friends, even family members. Accept that as a fact. It goes with the territory. You're in trouble because you've made commitments that are impossible to keep. To survive, you may have to step on a few toes.

This book is divided into three parts. These three are, in order of priority:

- Surviving
- Stabilizing
- Thriving

Surviving is about settling obligations so you can get on to more important tasks. Expect your survival phase to last about 18 months. *Stabilizing* keeps you from stumbling back into survival mode. You're building a foundation for the next level. Allow about a year to get stabilized. *Thriving* can last the remainder of your productive career. This is where you start to make serious money. You can hire an operations manager to lighten the load. Then your focus can shift gradually from business to pleasure.

How Bad is It — Really?

Working capital (money in your checking account) is like blood flowing through your veins and arteries. You don't think much about it while there's plenty to go around. But if that circulation stops, even for a moment, you're in trouble. Bad things happen when you simply don't have enough cash to meet payroll or pay taxes or take delivery of a COD shipment. That's a cash crisis. You have to do something quickly to stay in business. The more obvious your financial difficulty and the longer that difficulty lasts, the more concerned your creditors, employees, vendors and clients become.

There's a lot you can do, even in a severe cash crisis. More on that later. But we can all agree it's best to avoid the awful moment when there's simply no money on hand to meet an urgent payment deadline. The cause can be as simple as a client's check bouncing, or a customer deciding to delay a progress payment. The result is the check you wrote yesterday is going to bounce if you're not at the bank tomorrow morning with a deposit — for $500 or $5,000 or $50,000 or $500,000.

No matter the reason, you've got a problem. What are you going to do?

Your initial reaction is probably panic. That's OK. Mine would be too. It's perfectly natural to feel that way. But it's not very helpful. Neither rage nor depression helps in a cash crisis. Don't waste time wondering how you got into this mess. For now, let's figure out what to do about it.

Take a deep breath. Think this through logically and see what can be done. Start with the big picture. How bad is it — really? To understand that, you'll need a financial statement listing your assets and liabilities (what you own and what you owe).

Begin by making a copy of Figure A1-1 from Appendix 1 in the back of this book. This is a blank financial statement. Fill in the columns labeled Assets and Liabilities as accurately and honestly as you can. At this stage, what you need most is the unvarnished truth — a clear picture of where you stand. The more you know about the hole you're in, the easier it will be to climb out. If you're computer savvy and have Microsoft Office, use an Excel spreadsheet to create a financial statement. A computer spreadsheet is easier to modify, and does the math for you.

If you're not computer literate, no problem. Pencil and paper work almost as well. Anyhow, this is no time to start learning a computer program. Save that for when the business has stabilized.

Whether you use Excel or pencil and paper on Figure A1-1, list everything you own under Assets, whether it's paid for or not. Under Liabilities, list everything you owe, even if the asset is pledged as security for a loan. Total the columns and compare the numbers. The difference between the two is your Net Worth. See Figure 1-1.

Let's go over that in a little more detail, to be sure you get it right. An incorrect financial statement, at this stage, is possibly worse than none at all.

Enter your name or your company name and the date on the top of the sheet under Financial Statement. Under the heading Assets list, by type, all the money and assets of value you or your business owns. Start with current

FINANCIAL STATEMENT

NAME: TWICE RIGHT CONSTRUCTION DATE: 05/06/07

No.	ASSETS	AMOUNT	No.	LIABILITIES	AMOUNT
1	CASH IN BANK	$3,100	1	VALLEY LUMBER	$55,760
2	LOANS DUE YOU	$2,450	2	ABCO PLUMBING	$66,420
3	INSURANCE POLICY VALUE	$2,550	3	JOHNSON ELECTRICAL	$66,220
4	RECEIVABLES	$69,780	4	PHILLIPS HEATING	$89,040
5	CURRENT CONTRACTS	$87,800	5	CURRENT CONTRACT COSTS	$47,000
6	INVENTORY	$77,400	6	CREDIT CARDS	$10,690
7	REAL ESTATE	$175,000	7	IRS	$55,880
8	AUTOS AND EQUIPMENT	$34,600	8	EAST BAY SAVINGS	$257,880
9	OFFICE FURNITURE	$32,670	9	SOUTH FEDERAL BANK	$147,550
	TOTAL ASSETS	$485,350		TOTAL LIABILITIES	$796,440

NET WORTH: $485,350 - $796,440 = (- $311,090)

Financial statement
Figure 1-1

assets — cash in your checking or savings account, receivables, inventory, stock or bonds, the cash value of insurance policies, and any advance payments you've made before receiving the goods or services. Opposite each category write the present value of that asset. Below your current assets, list your fixed assets by category and value. Fixed assets are land, equipment, furnishings, vehicles and buildings. Include the value of each fixed asset, and calculate the total value of all the assets listed.

On the right side of the sheet, under Liabilities, list by category everything you or your business owes — mortgages, charge accounts, loan balances, anything received but not yet paid for, money owed to subcontractors, invoices still unpaid and the like. Calculate the total figure for the liabilities section.

On the last line at the bottom of the page, subtract the Liabilities from the Assets to determine your Net Worth. That's the Basic Equation of Accounting.

ASSETS − LIABILITIES = NET WORTH

Net worth is the total of all your assets less all your liabilities. It shows what you or your business is currently worth. If your net worth is negative, you're "in the hole." It's not a great position to be in. But knowing your net worth is enlightening, even if it's negative. Knowing a large truck is coming head-on is better than not knowing. At least you can make a plan to get out of the way.

In this case, it looks pretty bad, doesn't it? Your assets minus your liabilities equals a negative net worth. And it's seriously negative, to the tune of $311,090. That's a big hole and it's going to take some serious work and a long time to get out of it. But no matter *how bad it looks, you can survive*. The alternative is to file for bankruptcy. However, it's far too early to think about that. After you've tried everything in this first section of the book, if you still can't see a way out of the hole, bankruptcy is something you may have to consider. For now, let's be positive and concentrate on surviving.

The form you copied to list your assets and liabilities doesn't really conform to GAAP (Generally Accepted Accounting Principles), which we'll introduce in Chapter 2. But for now it's fine — it shows your assets and liabilities in their starkest light. At this stage, you just want to know where you stand.

The very first thing that you should realize about surviving is that *your problem is now all about debt management*. The two most common payment problems you'll face are:

1) Paying for the supplies you need to continue the contract that you're presently working on, and

2) Finding the funds to meet next week's payroll.

Let's spend some time looking at debt management.

Let's say that the economic cycle (we'll talk about this later on) has "gone south," and in spite of all your planning, losses on previous jobs have left you with a pile of unpaid bills. There's still money coming in from progress payments on the current job, but it's not enough to clear up all your debts from previous jobs. Here's your dilemma. Who gets paid? Should it be suppliers and subcontractors on your current job, creditors from the prior jobs, the most insistent creditors, or a little here and a little there to try and keep everyone happy?

Transferring Debt

If you use income from current work to pay creditors from previous jobs, that's a form of debt transfer. There's a serious flaw in transferring debt. *It doesn't work!* You only succeed in creating a whole new set of unhappy creditors — the ones you're working with on your current job. Instead of one group of suppliers and subs who won't work with you any more, you now have two. You create one additional unhappy group of creditors each time you transfer your losses on previous jobs. Eventually word will get around that you sting everyone you work with, and no one will work with you anymore. Avoid transferring debt. It's notoriously unsuccessful.

There's only one kind of cash it makes sense to transfer from one job to another — the real profit that's left over after all the bills have been paid. If you're not in a position to do that, *pay your current bills first*. You have to stay in business to pay off debt. Paying the debts on your current jobs keeps you in business. If you go out of business, everybody loses — especially your oldest creditors.

You Can't Make it Up in Volume

Have you heard the story of the two brothers who decided to go into the apple retailing business? The very first day they were in business they bought a truckload of golden delicious apples at $32.00 a bushel, and drove it to market. Unfortunately, when they got there they found that apples were selling for $30.00 a bushel. But the brothers were in the apple business, so they hung in there and sold off all their apples. Then they added up the receipts for the day and discovered a big problem. The older of the two brothers sat down to think up a solution. After some time had passed, he approached the younger brother with his answer. "What we need," he said, "is a bigger truck."

The moral of the story is simple. If you're losing money, more volume will only help you lose it faster. Another way of putting this is, "*If you're in a hole, stop digging*."

Don't fall into this "more volume" trap. It's an illusion. If you're losing money, volume isn't the answer. It only compounds the problem. Sure, more volume may produce more revenue. But *increased volume almost always requires accepting less profitable work*. That can be fatal for a contractor who's already in a profit squeeze. You're far better off making a good profit on one job than a marginal or no profit on ten.

For example, suppose you do a $200,000 job and make $20,000 profit after the bills have been paid and you've taken your salary. You've made a 10 percent profit. Now let's say you do a $1,000,000 job and make $80,000 profit. Sure, you've made a lot more money, but your profit is down to 8 percent. While it usually takes more volume to make more profit, every extra dollar in volume won't automatically produce a proportionate increase in profit. And if you're not careful, you may take on a job that turns into a real loser. Remember that greater volume requires more time and effort on your part, as well as more staff, equipment and overhead, all of which have to be paid for. The greater the volume, the greater your potential loss.

Of course, there's an exception to the rule. If you have high fixed assets, which are underused, such as a bulldozer and a backhoe, you have to amortize their costs over a small volume of business. This significantly increases the fixed overhead you have to charge to every job, so in this case, more volume is precisely what you need. Full utilization of high cost fixed assets is what you should aim for, but until you have a sufficient volume of business to allow this, it's much better just to rent equipment when you need it.

Volume isn't the answer — profits are. If you're ever going to get out of debt, you need to make a decent profit on each and every job. The money you include in your job estimates for your own supervision time (that's your salary) will feed and house your family. The overhead allowance you include will keep your office running and pay for your equipment. But only actual job profits will help you pay off old bills. If you don't make profits, you won't get out of debt, no matter how many jobs you do. It's as simple as that. And remember, it's very important not to confuse the profit on a job with your salary. Keep your company accounts and your personal accounts separate. Profit on a job is the money that remains after you've paid all your bills and you've paid yourself a salary.

Making money in the construction business is a lot like football. It's the short yardage plays that win games. It's consistency, day in and day out, that finally wins, not necessarily the long "bombs," though the occasional long bomb can really help. However, they generally come with significant risk. To continue the football metaphor, realize that a large construction contract can result in a significant monetary loss, just as the long, down-field pass can be intercepted and run back for a touchdown. Unless you're financially sound, one large loss could mean the loss of your business.

"If you don't make profits, you won't get out of debt, no matter how many jobs you do."

Try to avoid the lure of the big job until you've got the resources in place — staff, equipment, cash and management. Grow into volume gradually. Don't try to create it instantly. In the construction business, ten years is no time at all. The big volume contractors are mostly third-generation companies. How can you hope to compete with them? They've got a 100-year head start on you!

Take my advice. Do what you do best and make a decent profit at it every time you do it. If you work consistently and conscientiously, eventually you'll achieve the volume you desire. But don't leap into a volume operation on the backs of unsuspecting customers, suppliers and subcontractors.

Finding a Group and Regrouping

To dig out of debt, you must first regroup. By that I mean reorganize to cut expenses, even if it means going back to working with your hands for a while. If you're using the supervision money in your bids to pay a foreman, stop. A foreman on the job is eating into your profits. You'll never pay off your debts that way. If you're paying a secretary and a bookkeeper, it's time to let them go. Have your spouse or partner answer the phone and do the books.

If you own expensive equipment, sell it and rent equipment when you really need it. You're in no position to play super-contractor at the moment. High loan payments on idle equipment, unnecessary staff, and extravagant overhead costs will soon bankrupt you. If you can't stand the thought of answering your own phone, driving an older model truck and working on the job yourself, turn directly to Chapter 3, which deals with bankruptcy, because that may be your only alternative.

Regrouping is a slimming down process. It's reorganizing your operation to eliminate under-used labor and assets. It's also establishing or re-establishing a working group of professionals that can help salvage your business. This group should include an attorney and a certified public accountant.

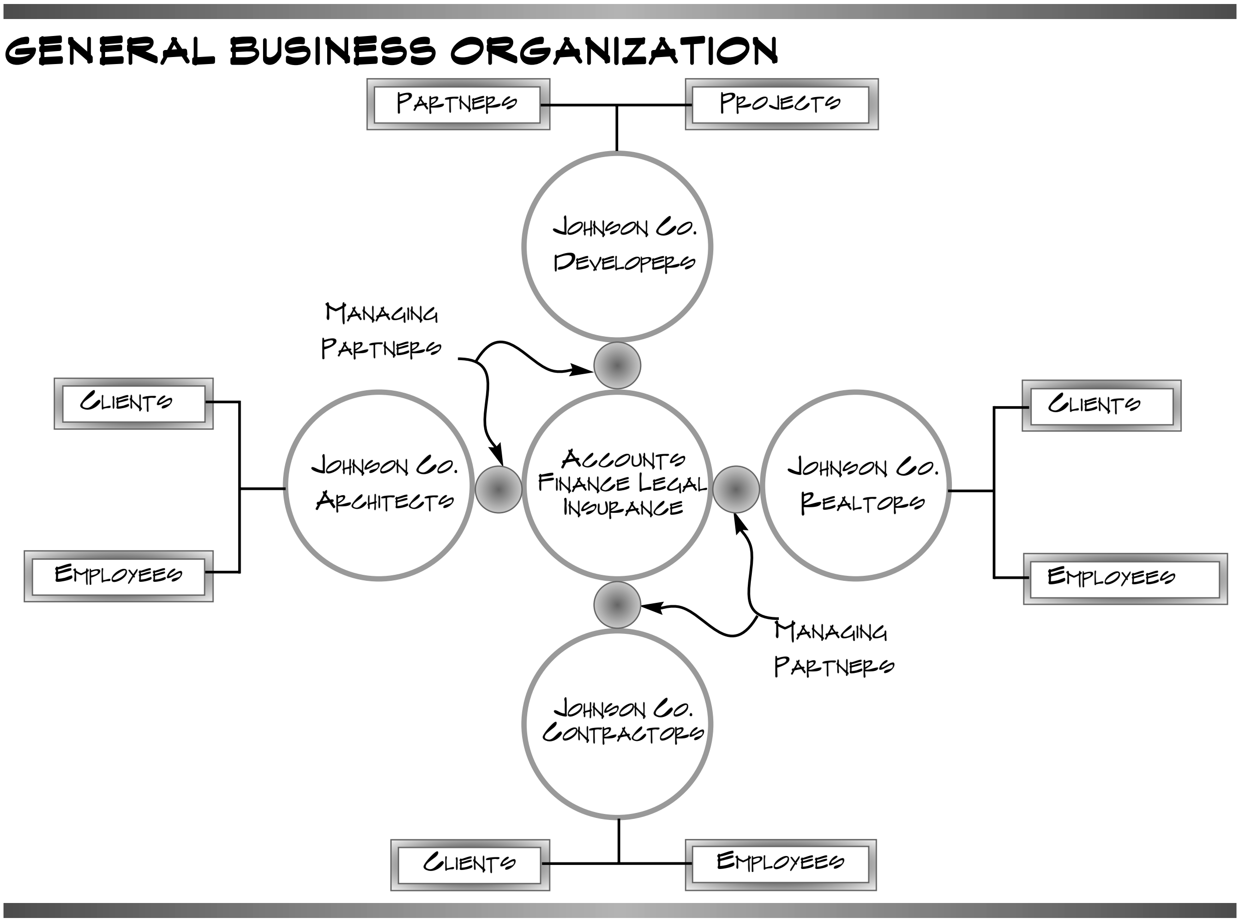
Here's my formula for regrouping a construction business on the brink of bankruptcy.

Start by evaluating the people who currently work with you. Review the performance of each one. Look at what each of them costs you annually and what you're getting for your money. If your attorney charges you for every phone call he places and each letter he writes, you have the wrong legal counsel for your kind of business. You can't afford him. He may be OK for IBM, but not for you. You'll go broke trying to continue to pay him. However, your attorney shouldn't be a family member or a relative, either. Relatives are usually too close to your problems to be impartial, frank and realistic. They'll become "yes-men" if you let them. What you need is an attorney who has nothing to lose by telling you just how bad things really are, and who's willing to work for a small, fixed monthly retainer, with a minimum charge for extras.

It's a good idea to try and find an attorney who may need your construction services. An attorney who's going to build a new home in the future, or an addition, or do some remodeling, may be willing to trade services. That helps you hold the line on legal expenses. But select a lawyer with the background and experience you need. My advice is to find a lawyer who specializes in real estate and construction work.

"Don't hire outside help if you or a family member can do the job..."

Follow the same rule when selecting an accountant. Certified public accountants are licensed by the state and are responsible for their errors and omissions. A bookkeeping service or unlicensed accountant usually costs less but may be much less reliable and nowhere near as helpful. Also, CPAs usually know more about tax laws, partnerships and corporate procedures, which may be useful.

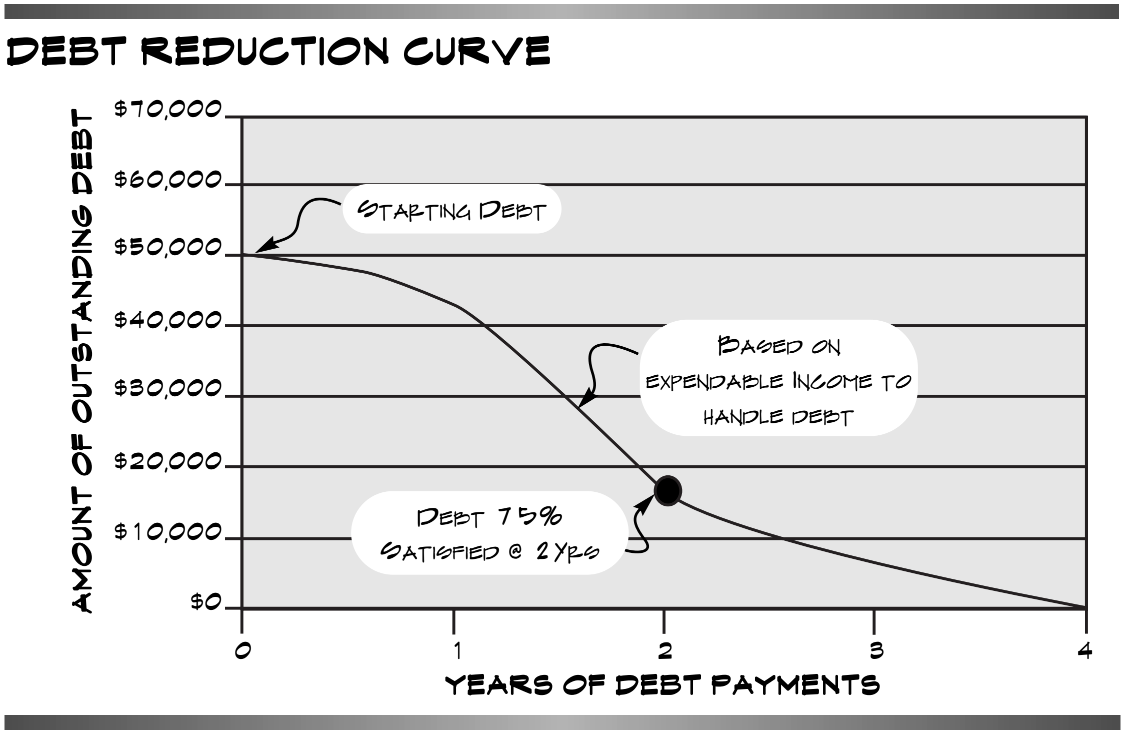


General business organization
Figure 1-2

Find professionals who are mature and stable. This may take time — but getting good legal and financial advice at a reasonable cost is worth the time and effort. When you regroup, make your organization as streamlined as possible. Don't hire outside help if you or a family member can do the job and keep the money at home. You may need to invest that money back into the company. If you're running several different companies, it's time to consolidate them into a single company. If you're operating as a corporation, consider the advantages of sole proprietorship. A corporation requires additional reporting and at least a few hundred dollars a year in corporate taxes. That money would be better used to pay overdue bills. Figure 1-2 shows that successful businesses are organized around a single core of common services.

How Long In? How Long Out?

How long will it take to get out of debt once the company has been streamlined and regrouped? That depends on how deep the debt is. There's no single answer. Some companies will never recover. But here's a rule of thumb



Debt reduction curve
Figure 1-3

that seems to work. It will take about twice as long to get out of debt as it took to get into debt. If two years of mistakes caused the problem, allow yourself four years to fully recover. About 75 percent of your debts should be paid off in the first two years. The remaining 25 percent may well require another two years. See Figure 1-3.

Paying off debts takes longer than creating them because a company deeply in debt has to reduce volume drastically to survive. Your ongoing volume may be only one half, or even less, of the volume you were doing when times were good. During the growth phase of the construction cycle (see Chapter 5), it's easy to make money. *But builders don't go broke during good times.* They buy assets that they expect to re-sell or develop. They generally go broke when work slows down or comes to a virtual halt. This generally occurs due to slowing external economic conditions, but not always. It could be that your business has slowed down due to something you've done to "soil" your company's reputation. That's when it's hard to make money, and harder still to get free of debt.

If it took a year for you to get into serious debt, you'll spend the next year stalling, buying time, reorganizing and looking for profits. During that first year you'll pay off only 15 or 20 percent of your debts. In the second year you'll develop a steady cash flow that can begin to pay off bigger chunks of your outstanding obligations, maybe 50 or 60 percent of the remaining debt. The last few creditors may have to wait for your third or fourth year of recovery.

Some creditors won't wait that long. But if they're going to sue, it will happen during the first year of your recovery. We'll discuss in depth the ways of handling lawsuits in Chapter 3. Remember also that 15 to 25 percent of all your debts will go away by themselves — some of your creditors will simply write off your debts (and never do business with you again), get out of the construction business altogether, or simply go broke themselves.

Being Threatened with Lawsuits?

"*I'm going to sue you!*"

If you owe money and can't pay, you're going to hear those words a lot. Of course, not everyone who threatens you with a lawsuit will actually sue. But probably one-third of your major creditors will sue you when they discover you can't pay your bills.

However, if you don't have any assets to lose, there's little reason to worry — surprisingly! Nobody can take away from you what you don't have. The courts can't, nor can anyone else. Nor can they throw you out of your home (see Chapter 3, Homesteads) or take away your means of making a living. If you're technically broke, relax. All they can do is to get a judgment against you that's impossible to satisfy. There's nothing they can levy against. Believe me; being broke is safer than being very rich!

"Think of lawsuits as your creditors' last desperate gasp."

Of course, your secured creditors will take back their security. The bank will take the tractor they hold the paper on. Mortgage holders on land you "own" will get the land back. But that's all they'll get. As long as something isn't encumbered or in your name, it's hard for creditors to get at it. Generally they can't get any more, if the security tendered is worth less than what you owe them. And even getting the security back may take them a year or more.

Think of lawsuits as your creditors' last desperate gasp. They're trying to collect what they're owed, and maybe punish you as well for giving them a hard time collecting it. But don't worry. Getting sued isn't so bad. Just keep your eye on the goal. What you want is to maintain as much control of events as possible. It's the loss of control that's scary, not the lawsuit itself.

Here's a typical example. You've been sued by an irate creditor. Because you've got some assets that you want to protect, you file an answer to the suit. That only costs about $500 to $1,000, and any attorney can do that for you. Even if you have no defense to the suit at all, you're at least a year away from trial. All during that time you remain in control. Your creditor can schedule depositions or make motions in court. But he probably won't, because from his standpoint that's just throwing more good money after bad. And his attorney doesn't want to waste any more time than is necessary on this matter.

Collection attorneys get paid a fixed percentage of what they collect, not by the hours worked. So they play the odds. If you look like you're in such bad financial shape that the odds are heavily against their collecting anything, they won't waste their time on you.

There's going to be delay in any suit. That leaves you free to get on with the business of surviving and laying the foundation for your recovery. Unless there's an injunction, you can sell assets, finish your current jobs and start new projects. Meanwhile, your creditors are tied up by the cumbersome legal system they decided to use.

They can only wait, often for a year or two, for the suit to come to trial. Meanwhile, in effect, you have the use of their money.

Understand, I'm not advocating this as an honorable way of conducting business. It's certainly not fair to your creditors. But it is, nevertheless, the way our legal system works. Try to remember this — bureaucracies move slowly. When a creditor elects to use the legal bureaucracy to solve his problems, he puts time on your side.

Debt Organization and Priorities

With your creditors stalled, at least temporarily, let's turn our attention to organizing your debt load. Here's how you're going to do it.

Income Inventory List

Start by listing your immediate sources of income and assets. Make a copy of the blank spreadsheet that you'll find in Appendix 1, called Income Inventory, and list every source of income and assets you can think of. Again if you're computer savvy and familiar with the Microsoft Office suite of programs, you can make up your own Income Inventory spreadsheet. If not, just make a copy of Figure A1-2 in Appendix 1. Include in this Income Inventory list every dollar of profits, overhead, supervision and subcontract work you can pull out of the monthly progress payments for each job you presently have under contract.

Remember, you're not going to use the payments you receive from your current job(s) to pay off the debts on your previous jobs, if those payments have already been committed to pay bills on the present job(s). You can use the profit that is included in those payments, but not the money needed to

INCOME INVENTORY

NAME: TWICE RIGHT CONSTRUCTION DATE: 05/06/07

No.	ITEM	SOURCE / ACTION	AMOUNT
1	CAL STATE UNIVERSITY	BUSINESS CONTRACT	$24,200
2	JONES RESIDENCE	BUSINESS CONTRACT	$2,000
3	ALAMEDA LOTS	SELL	$65,000
4	SIERRA PARK DISTRICT	BUSINESS CONTRACT	$4,760
5	COMPANY AUTOMOBILE	SELL	$10,500
6	COMPANY TRUCK	SELL	$13,500
7	HOUSE	RAISE 2ND MORTGAGE TRUST DEED	$10,000
8	MISC. BUSINESS EQUIPMENT	SELL	$7,000
9	JEWELRY	SELL	$5,500
10	PERSONAL AUTOMOBILE	REFINANCE	$4,750
11	RENTAL HOUSE	SELL	$22,000
12	GENERAL MOTORS STOCK	SELL	$15,200

TOTAL $184,410.00

Income inventory list
Figure 1-4

pay your current bills. So the only way to release any additional money other than the profit, is to undo some existing commitments. This means reducing the staff you have to pay, and doing the overhead work, the supervision and perhaps even some of the subcontracting work yourself, or with less expensive help, if you can find it. You may get tired, but at least you'll get solvent!

Now add any stocks, bonds or promissory notes owed to you. Add any equity in equipment, inventory and real estate you own. Finally, add any personal items, such as jewelry, stamp collections or whatever, which have significant market value. Include everything of substantial value — yes, disposing of some of these personal items may be painful, if it comes to that, but remember you're in a desperate situation, and desperate situations demand desperate measures. Figure 1-4 shows what an Income Inventory list should look like.

This income inventory list identifies your monthly income and the value of your assets. You're probably not going to use all of these monies to satisfy creditors. But some could be sacrificed to keep you going. When you've decided which of your inventory items to liquidate for cash, remove those items from your income inventory list, apply the cash to pay off some of your debts, and re-total the right column. What remains is what you have to work with to handle your remaining debts. See Figure 1-5.

INCOME INVENTORY (ADJUSTED)

NAME: TWICE RIGHT CONSTRUCTION DATE: 05/06/07

NO.	ITEM	SOURCE / ACTION	AMOUNT
1	CAL STATE UNIVERSITY	BUSINESS CONTRACT	$24,200
2	JONES RESIDENCE	BUSINESS CONTRACT	$2,000
3	SIERRA PARK DISTRICT	BUSINESS CONTRACT	$4,760
4	HOUSE	RAISE 2ND MORTGAGE TRUST DEED	$10,000
5	PERSONAL AUTOMOBILE	REFINANCE	$7,250

TOTAL $48,210.00

Income inventory list (adjusted)
Figure 1-5

Indebtedness Priorities List

Now you need to prepare a list of your monthly living expenses and outstanding bills. Make a copy of Figure A1-3 in Appendix 1, called Indebtedness Priorities, or simply make another Excel spreadsheet divided into three vertical columns, headed Living Expenses, Payable Expenses and Unpayable Expenses.

Column one is for essentials only. They'll be paid 100 percent each month. After all, you've got to live, though you'll have to cut back on some discretionary spending, such as clothing and entertainment. Column two is for creditors who you plan to pay in small monthly payments (you'll need to get their agreement, of course). Column three is your wish list . . . no payments at all for the present; just a big wish. But be up front with these creditors. Tell them their name is in the hat. If they object, you can always offer to take their name out of the hat.

In the first column, list your minimum monthly living expenses by type — food, shelter, clothing, utilities, health, transportation, education and incidentals. In the second column, list all of your small debts. These are debts under $3,000, plus anything owed to suppliers necessary for current business operations. In the third column, list all your remaining debts — anything over $3,000 that's owed to anyone, and/or isn't essential to your current contracts or your recovery plan. These are debts that can't be paid from presently available income. See Figure 1-6.

Include in column three creditors that have already sued you or seem intent on suing you. Other candidates for this column include your more hostile and stubborn creditors. If you have some large corporate creditors that are just following procedures in the company directive, "How to

INDEBTEDNESS PRIORITIES

NAME: TWICE RIGHT CONSTRUCTION DATE: 05/06/07

NO.	LIVING EXPENSES		PAYABLE EXPENSES		UNPAYABLE EXPENSES	
1	MORTGAGE	$1,095	MID BAY SUPPLY	$94	SIERRA SUPPLY	$10,940
2	FOOD	$570	JOHNSON LUMBER	$500	HAL'S PLUMBING	$5,560
3	UTILITIES	$350	ACME ELECTRIC	$350	L&D CONCRETE	$7,980
4	PHONE	$75	J&T HARDWARE	$135	JOHN HANSON	$4,300
5	INSURANCE	$220	BILL'S ROOFING	$170	BUD'S REPAIR	$3,560
6	MEDICAL	$650	TAXES	$150	JIM'S RENTALS	$1,300
7	CLOTHING	$200	MISC.	$75	T&M GUNITE	$17,520
8	ENTERTAINMENT	$75			VALLEY LUMBER	$12,360
9	GAS/AUTO	$530			BOB MURPHY	$1,690
10	MISC.	$150			SECRETARIAL SVC.	$870
Totals		$3,915		$1.474		$66,080

Indebtedness priorities list
Figure 1-6

Handle Past Due Accounts," put them in column three. Smaller creditors with a belligerent attitude should also go in column three.

If any creditor in column two sues you, move him immediately to column three and stop making any monthly payments. Replace him with someone more reasonable from column three, and begin making monthly payments to that creditor.

The overriding purpose of debt organization is to eliminate as many small debts as possible, as quickly as possible. That's column two. Column three creditors will have to sue you or wait until they're paid voluntarily. You'll have to accept, of course, that this will be the end of your working relationship with them.

Be honest with your creditors. Tell them each and every time they call that you ultimately plan to pay them in full. Be friendly, forthright and optimistic. Shouting and threats won't help anyone. This is strictly business. No moral issues are involved. But don't guarantee any specific time for payment. Just let them know that you have a list of creditors, that they're on that list, and that they will be paid as soon as money will stretch that far. But you have to feed your family first.

You'll repeat that same conversation over and over until your creditors become exasperated and give up on arm twisting. Then they'll either sue you or assign your debt to a collection agency. This is exactly what you expected when you made up your Indebtedness Priorities List. You've been as honest as possible with each creditor. You intend to pay every creditor in column three, and you've told each one of them exactly that. At this stage, there's not much more you can do.

What you need is time — and lots of it. Organizing your debts and payment priorities will buy you that time. You may not like what you're going through, but a builder in deep financial trouble has no other choice. Remember, the whole point of Part I of this book is survival. If you don't survive, nobody gets paid. Everybody loses.

Too Little Debt

Owing a creditor too little money can be a problem. Most states have a small claims court system that lets creditors sue without an attorney, and get a judgment in about a month. That can be dangerous for you. The sheriff could be camping at your door or drawing money out of your bank account about 60 days after you're sued. That makes small claims court a potent threat.

Fortunately, there's an upper limit on small claims court actions, though recently, there's been a trend towards increasing small claims court limits, making it much more favorable to creditors. The upper limit is normally somewhere between $3,500 and $7,500, depending on your state. For instance, the maximum amount is $3,500 in Vermont, $5,000 in New York and Texas, and $7,500 in California and Minnesota, but it's $15,000 in Delaware and Georgia. Hardly small claims any more! To find out the limit in your state, go to your internet browser and type in www.nolo.com then click on Rights and Disputes, then Consumer Rights, then Small Claims Court and finally, "How Much Can I Sue for in Small Claims Court?"

That's why I recommend paying off the small debts as soon as you can and ignoring the larger ones for the present. An option a creditor does have, if you owe him more than the limit for a small claims action, is to forego that portion of the debt that's over the small claims limit, and sue in small claims court for only the maximum allowable amount. But if he doesn't want to give up the excess amount, he'll need an attorney and many months to collect. That's to your advantage.

How much can you owe a creditor and hope to stay out of small claims court? A good rule of thumb is 50 percent or more of the maximum small claims court limit. Few creditors will hesitate to lop 10 percent off a delinquent bill in order to get paid through a small claims court action. But most won't give up 40 or 50 percent. After all, they worked hard for that money. They won't give it up without a fight.

Here's something to keep in mind, however. If you can stall a creditor by owing him more than the small claims limit, *your debtors can do the same to you*. No one has a monopoly on this information. It's available to anyone. When you're writing the original contract for a job, consider setting up the agreement so that the final payments you receive from your client are no larger than the small claims limit in your state. Then if the client stalls on the final payment for no good reason, get him into small claims court immediately and save the one-year plus wait for your money.

Remember, most creditors are just like you — in debt. They're just in debt to different people. To work successfully with debt, you must keep it in perspective. Everybody owes money to someone. It's nothing to be ashamed of. After all, the vast majority of homeowners have a mortgage, which, of course, is debt. But if the homeowner and the mortgage company have done their job properly, it's manageable debt. It's unmanageable debt that's the problem. A heavy debt burden in relation to income is something to be genuinely concerned about.

While battling to hold off creditors, remember that they're in the same predicament as you are. They fight their receivables every day to stay current on payables. They have to collect from you and others like you in order to survive. You also have to collect to survive. Collections are a significant part of a contractor's job; they don't happen automatically. Get comfortable with making collections. It comes with the territory.

Once you're back on your feet, take a solemn oath to maintain a balance between debts and assets. Debts shouldn't be more than about 50 percent of assets. The bank would use a similar yardstick when making a loan on your house. Cash reserves (including liquid assets that can be turned into cash quickly) should be at least 10 percent of total assets.

Collection Agencies and Your Credit Rating

Here's how to handle collection agencies — ignore them. Until their attorney sues you, don't even give them a thought. If they sue, tie them up in court for a year or two. A collection agency has to follow the same procedures as any other litigant. They have no special advantages, and they have one big disadvantage. They don't know all the facts about your debt.

But you know one important thing when a collection agency comes calling. That means that the creditor has given up on the debt. He's assigned it to a collection agency. The agency gets about a third to one-half of everything they collect. Who wins on that assignment? No one but the agency, of course. They have to work only once for their money. But their time is precious too, and they'll spend their time working on those debtors they feel they'll most likely be able to collect from. So make it appear that it'll be tough to collect anything from you, and they won't waste too much of their time hassling you.

When you're sued and lose, an abstract of that judgment is recorded at the county recorder's office. This isn't cleared until the debt is paid off. The abstract attaches as a lien to any real property you own in that county, but not in any other counties. Collection agencies and credit associations run a similar record-keeping system on debtors. A collection agency puts your name on file with local and national credit reporting associations for seven years.

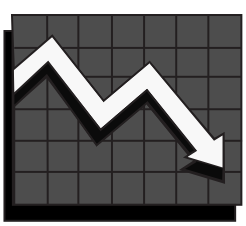
If a collection agency is operating within its legal rights, there's not much you can do but tolerate them. But the law limits contact with you to no more than once a day. If a bill collector becomes belligerent or contacts you late at night, feel free to hang up or slam the door.

Ignore telegrams and "24-hour" written notices. They're effective only against unseasoned debtors who take them seriously. The collection agency's greatest weapon is harassment. It's the squeaky wheel that gets the grease. That's their philosophy in a nutshell. Don't let yourself be intimidated. Be courteous and candid, as long as they treat you with respect.

The law regulates what collection agencies can and can't do. Much of what they can and can't do is listed in Figure 1-7. For more information check out the www.fair-debt-collection.com Web site.

"The collection agency's greatest weapon is harassment. It's the squeaky wheel that gets the grease."

You can get a copy of all the information in your credit file(s) from one or all of the three national credit reporting agencies or bureaus: Experian, TransUnion or Equifax. This information is not available to the general public. An excellent Web site to check is www.myfico.com. You have to give creditors permission to review your data. That's something you do routinely nearly every time you fill out a credit application.



Credit ratings affect your life in several ways, such as the ability to get a new loan, the interest rate that you'll have to pay on that loan (the worse your credit score, the higher the interest rate that you'll have to pay), and the interest rate on your credit cards, which can be changed at a moment's notice. Your credit score, typically called a FICO score because it's based on a formula developed by the Fair Isaacs Corporation, is usually a number between 300 and 850; the higher number the better. Your score is based on five factors:

1) **Payment History** – What is your track record of on-time payment?

2) **Amount Owed** – How much is too much?

COLLECTION AGENCY ACTIVITIES

LEGAL ACTIVITIES	ILLEGAL ACTIVITIES
1 CAN CALL YOU AT HOME	1 CAN'T HARASS YOU (VERY VAGUE)
2 CAN VISIT YOU AT HOME	2 CAN'T CALL YOU REPEATEDLY
3 CAN SEND NOTICES OR LETTERS TO YOUR HOME OR PLACE OF BUSINESS	3 CAN'T CALL YOU AFTER NORMAL BUSINESS HOURS, (I.E. 8:00AM - 8:00PM)
4 CAN TALK WITH YOUR SPOUSE, OR PARTNER	4 CAN'T CALL YOU AT WORK WITHOUT YOUR PERMISSION
	5 CAN'T VISIT OR TALK TO YOU AT YOUR PLACE OF BUSINESS
	6 CAN'T CONTACT YOUR FRIENDS OR NEIGHBORS

Collection agency activities
Figure 1-7

3) **Length of Credit History** – How established is yours?

4) **New Credit** – Are you taking on more debt?

5) **Types of Credit Used** – Is it a "healthy" mix?

Details of how each of these factors is scored and the weight given to each can be found at www.myfico.com. It will also tell you how you can improve your credit score, if you find that it's lower than you think it should be, based upon how you've used credit in the past.

Your credit rating can vary from month to month and year to year as your ability to meet your obligations changes. If you've developed a poor credit rating, consider placing an explanation in your credit file. That can be done at any time. But you should do it as soon as you've turned the tide on your financial difficulties. Just the dry facts about your credit problems can look pretty bleak if there's no explanation or suggestion that you're on the road to recovery.

But there's hope, even if your credit report looks really grim. A funny thing happens when you have money in the bank. Maintain a respectable balance and stay current on your obligations to the bank, and your credit rating doesn't mean a thing when it comes time to apply for another loan from the bank. Money talks. If you have cash in the bank, suddenly your credit history with that bank is as clean as new-fallen snow.

Trading Services and Working Off Debts

Trading services is nothing more than the old-fashioned barter system. But it has one outstanding advantage — the Internal Revenue Service has a hard time taxing income and profits on services received through barter. Since no money actually changes hands in the barter system, there's no paper trail for anyone to follow.

Bartering isn't as convenient as using cash. But bartering works when people lose confidence in cash, or when cash is scarce. The trouble with bartering is that it's hard to find someone who both needs what you've got to offer, and can offer what you need. But if you're buried in past due accounts, you have a ready-made list of bartering prospects — your creditors. These people have needs — the money they're owed. What can you offer them? It's always worth asking — you'll never know until you ask.

You may be able to liquidate or reduce your debts by doing some remodeling, or an addition, or by building new facilities for a major creditor at a discounted price. Do you have a boat you can trade for debt, or a cabin in the mountains that you can rent out at no charge for a couple of weeks? Negotiate debt reductions with your creditors. You can even provide some service for a creditor of your creditor, freeing up some of his cash so that he can pay *your* creditor.

The possibilities are limitless. It doesn't always require cash. All it takes is some imagination, and the guts to ask, "What do you need besides money?" Trading services for debt payment really works. And it's certainly preferable to a law suit.

Keep in mind that if you have a bank loan on anything — a house, a car, a boat, some equipment, etc., then you have a ready-made buyer — the bank. Don't sell your stuff, just drop off the keys at the bank and you're free.

Summary

The law is a funny thing. It lets any creditor chase you relentlessly, but makes the course long and tedious. And if there's no other way, the law may still let you beat your creditors out of their money through bankruptcy. You can't change the legal system. But you can use the system to your advantage. Take the time to make up a financial statement, an income inventory list and an indebtedness priorities list. These valuable tools clear your thinking on your debts and income. Remember, the objective in debt organization is to eliminate as many small debts as possible, as quickly as possible. Don't be intimidated by collection agencies.

They have to use the courts like everyone else. And don't overlook the opportunity to trade services for debt.

I've emphasized that creditors are not your adversaries. Think of them as disappointed friends. They were there to help you when you needed their labor and materials. *You're* the problem. You couldn't pay the bills when their work was done. It's not their fault that you underestimated the job they worked on, or you overspent your share of the job's income. Naturally your creditors are upset. They're disappointed with your business performance. You've created the image of being a poor business manager, and you may deserve it.

But images change. Deal honestly with your creditors. You're going to pay them eventually. When that happens, they can say that you were slow to pay. But if you've been straight with them from the moment it became clear you weren't going to be able to pay their bills on time, they can't say that you were dishonest.

"Recovering financially is going to make you a much wiser and more capable contractor."

Why bother to deal fairly with creditors? Two reasons. First, you're laying the groundwork for financial recovery. That's much easier if you preserve your reputation in the construction community. Everyone admires someone who manages to struggle back from insolvency, if he eventually pays all his creditors. Abraham Lincoln did it. So did Harry Truman. And both were later elected President. And more recently we've had examples of major corporations fighting back from Chapter 11 bankruptcy. Just think of K-Mart, who declared bankruptcy in February 2002, as their stock fell to junk status. They emerged from Chapter 11 fifteen months later, their stock rose to over $100 a share, and they ended up buying Sears.

But there's an even more important reason. You're going to come out of this with your self-respect and dignity intact. Recovering financially is going to make you a much wiser and more capable contractor. My recovery did that for me. It will for you too. It's inevitable. The most important benefit from working your way out of debt is what it does for you.

You went into debt of your own free will, though, of course, not by intent. You just let it happen. Now, by standing your ground, you're going to get out of debt. Fight your way back to solvency. That's the first step. The second is stabilizing your organization, before going on to the third step of building a profitable, financially-sound construction company. Think of the first step, survival, as the training ground for the following two steps. That's why you plan to pay every creditor and meet every obligation as soon as you can.

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Finding Money and Buying Time

The two things that you need most when you're in debt are money and time, and, of course, they're the two things that are always in the shortest supply. So you have to be imaginative and creative to make as much of both of them as you can. Let's look at the various ways that you can raise money to pay off the most urgent debts, the ones that were prioritized in the Indebtedness Priorities List in Chapter 1. Then a little later we'll look at the various ways of buying time.

Finding Money

The easiest way, in principle, to find money is to increase the profits in your existing projects and to reduce your costs. However, it may not be easy to do these things, and at least in the initial stages of your financial crisis you need to find cash quickly. If you can increase your profitable business volume as well, that's good, and we'll look at some ways of doing that in Chapter 9. But for now we'll assume that you have to find the cash you need from your existing business. It may not be easy to reduce costs, but it will certainly be easier than increasing business volume. You may simply have to bite the bullet, reduce your staffing and do the work yourself, or use less-experienced workers who command less pay than your existing staff.

However, in addition to finding new business and reducing costs, there are other ways of raising cash, from selling the assets you presently have, to borrowing more money. So let's start with liquidating some of the assets you currently have.

Value Determination – Average

No.	Valuer	Estimated Value	Loans or Liens	Equity
1	Eastside Realty	$163,500	$112,500	$51,000
2	Jones, Smith and Anderson	$183,000	$112,500	$70,500
3	National City Realty	$142,500	$112,500	$30,000
4	White, Martin and Associates	$156,500	$112,500	$44,000
5	Bowie River Realty	$196,500	$112,500	$84,000
6	Alton Street Investments	$169,000	$112,500	$56,500
Average Value - Total / 6 Valuations		**$168,500**	**$112,500**	**$56,000**

Value determination
Figure 2-1

Quitclaims and Liquidating Assets

There are several ways to sell assets. If you have real property assets that require monthly mortgage payments, look at them first. They may actually be more liability than asset. From a cash-flow point of view, it may be in your best interest to liquidate them as quickly as possible. But before you unload this or any type of asset, determine how much equity you have in the property.

A quick way to appraise real estate is to ask half a dozen local realtors to give you an appraisal of its value. They'll almost certainly do it free of charge if they think there's a chance they'll get the listing if you it put up for sale. The average of these six opinions is probably close to the fair market value. Now deduct all the loans and any liens you have on the property. The remainder is your equity. See Figure 2-1. If there's little or no equity in your asset, sell it yourself through a title or escrow company and avoid the realtor fees.

If the equity is nearly zero, consider using a quitclaim deed to transfer title of the property to the mortgage holder, who is always a ready-made buyer for you. A quitclaim is a valid deed. But it makes no promise or warranty about who actually owns the property. It only transfers whatever rights the seller has. If he has none, nothing is transferred. The deed is usually filed by the seller at the county recorder's office. Generally, filing a quitclaim deed relieves you, the seller, of any financial obligation connected with the property. If you choose to use a quitclaim deed to eliminate an obligation, use a document like Figure 2-2. You can purchase an official copy of a Quitclaim Deed document at www.ilrg.com/forms/quitdeed.html.

However, if you have substantial equity in your property, you'll need to find a buyer who can pay a good price. But before selling, consider giving yourself a *buy-back* option in the sale. This gives you cash now, when you need it most, but preserves your right to buy the property back on a certain date at a set

Recording requested by: ____________________________

When recorded, mail this deed and tax statements to

____

____

____

----- Space Above This Line Reserved For Official Use Only -----

QUITCLAIM DEED

The undersigned grantor(s) declare(s) for valuable consideration, receipt of which is hereby acknowledged,

Grantor ____________________________ Grantor ____________________________

Address ____________________________ Address ____________________________

Do hereby remise, release and forever quitclaim to:

Transferee ________________________ Transferee ________________________

Address ________________________ Address ____________________________

All right, title and interest in certain property located in:

County ________________________

State ________________________

And further described as (legal description):

____

____

____

Grantor signature __________________________________

Grantor signature __________________________________

Date __________________________________

Quitclaim deed (Cont. on reverse)

Figure 2-2

Certificate of Notary

State of ____________________________________

County of ____________________________________

On (date) ____________________________________

Before me (name) ____________________________________,

a notary public, appeared

Name of person signing ______________________________,

Name of person signing ______________________________

Personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies) and that by his/her/their signature(s) on on the instrument the person(s), or their entity upon behalf of which the person(s) acted, executed the instrument.

Witness my hand and official seal

____

Quitclaim deed (cont.)
Figure 2-2

price plus interest. Most private buyers will balk at an option like this, though a commercial buyer may not. However, it's always worth asking. It may work with friends or relatives who'd like to help you out, but want the security of an asset to protect their investment.

Factoring

After you've liquidated all of the assets that you can, the two other major sources of funds are borrowing and factoring. You'd probably look at borrowing next, since ways of borrowing money these days are plentiful. But remember that borrowing only buys you time and doesn't actually pay off debts, so let's take a look at another possible source of funding that *doesn't* increase your debt load.

Unless you've been very lucky, or you've done a superb job of checking the credit of your clients before you did any work for them, you've got some receivables that are difficult to collect. Though these may seem like liabilities at present, they're actually assets that you can convert to cash by *factoring*. In factoring, a lender, or factor, buys your receivables for cash. You get cash up front as soon as the account is due, and your creditors then make payments to the factor. However, you typically receive significantly less cash than the face value of the receivables, since the factor has to make his profit and he's taking a risk that the receivables may never be collectible.

Most major banks do some factoring of receivables. If you've spent a considerable amount of time with one bank, that's probably a good place to start looking for a willing factor. A search for *factoring* using an internet search engine (e.g. Google) will give you plenty of links to Web sites offering factoring services. You'll also get details about factoring that you need to know before you consider that approach to raising cash.

"Factoring can solve your cash flow problems if you're growing rapidly and have heavy receivables for a relatively short period."

If you don't have a computer yet, just go to your local library and ask one of the librarians to show you how to open up the search engine. Type in *factoring*, or any other topic that you need information on, and it'll all be there for you in an instant. The internet search engines have revolutionized the accessibility of information, making knowledge on almost any topic imaginable available at the touch of a few buttons.

Factoring can solve your cash flow problems if you're growing rapidly and have heavy receivables for a relatively short period. However, as mentioned above, the cost of factoring is high. If you have no other assets available, it may be your only alternative. But don't use it to make up for losses or to carry excessive overhead.

Factoring is no picnic. I've never seen a builder use it successfully for any length of time. Most contractors don't have heavy receivables from solvent debtors. But if you do, here's how the factoring system typically works. You assign a receivable to the factor. The factor deducts his fee from the invoice and sends you a check for the balance. The fee is usually 10 to 50 percent of the amount due. The older the receivable, the smaller the amount the factor will expect to collect; the less likely the debtor is to pay, the greater the factor's fee will be. As you can see, this is a desperate measure that should be reserved for desperate times.

Trust Deeds or Loans

There's a third approach available to raise cash — borrowing. Though I've stressed that borrowing money doesn't actually pay off debts, but only increases your debt load, it can spread out the period over which the debt has to be repaid. This can be significant if you have short-term creditors who are screaming for their money, while refusing to supply you with the materials you need to keep your business going. So with this caution, let's take a good look at the advantages of borrowing — we know the disadvantages all too well.

There are both secured and unsecured loans available. If you're trying to borrow money in a hurry to pay off bills, I'll assume your credit rating isn't particularly good, and you'll find it difficult to obtain an unsecured loan. So we'll be talking mainly about secured loans, for which you'll need the security of real property or some other asset of significant value, which you'll have to forfeit to the lender if you default on the loan.

If you own property in which the equity is large enough, consider taking out another loan on the property. It's a borrowing method commonly used by homeowners, called a second mortgage or second deed of trust, or more recently, a home equity loan or home equity line of credit. A home is a very negotiable asset when you're looking to borrow money. Banks make good money lending on single-family, owner-occupied homes. There can be even third and fourth mortgages on some properties. However, expect to pay a higher interest rate on a second or higher mortgage. There are considerably greater risks for the lender associated with these mortgages, as they are last in line if you default.

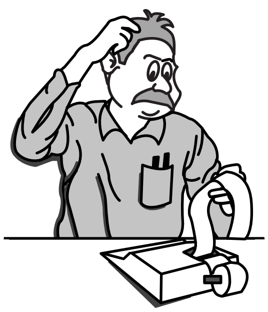
The original mortgage or deed of trust is entered at the county recorder's office and becomes a public record. The first instrument recorded is the most senior and has rights against all instruments recorded later. Later lenders on the same property can take title to the property only by paying off lenders who recorded their deeds of trust or mortgages earlier. That makes the first lender much more secure than the following lenders.

"A home is a very negotiable asset when you're looking to borrow money."

If you're financially solvent, it's usually easy to get a first mortgage of 80 percent or perhaps even 85 percent or 90 percent of the value of the property, in a strong housing market. And if the housing market has remained strong and the value of the property has appreciated, you'll find it fairly easy to get a second mortgage on the property from a bank. However you'll fight an uphill battle to get a third mortgage from a bank. So let's take a look at second mortgages as a means of borrowing cash to get you out of your credit squeeze.

Let's say you purchased a property two years ago for $200,000 with an 80 percent ($160,000) mortgage and a 20 percent ($40,000) down payment. So your equity in the property at that stage was $40,000. Now, if the housing market has been strong since you took out the first mortgage on the property, the appraised value of the property may have increased by 20 percent in those two years to $240,000 (it could have increased a great deal more in some areas of the country, particularly on the West Coast). Now you have $80,000 of equity in the property.

You may be able to obtain a second mortgage or home equity loan for up to 80 percent, 90 percent, or from some lenders, even 100 percent of that equity. 80 percent of $80,000, or $64,000. If you can get a 100 percent second mortgage you'd be able to borrow as much as the full $80,000! And some lenders may be even more aggressive, lending up to 125 percent of the equity in the property. However, expect to pay higher closing fees and much higher interest. You now owe the original $160,000 plus the second mortgage of $80,000, or $240,000, against the security of the property which you originally purchased for $200,000. Now you've got $80,000 to pay off your short-term creditors, and you can pay off the second mortgage over time. You might want to set aside $10,000 as a back-up in case you have trouble making the payments.



In the event you default on either of the two loans at some time in the future, the holder of the first mortgage is generally in a very strong position. And the second mortgage holder is also fairly safe as long as the second appraisal was accurate and the housing market remains strong. In that situation, the property can usually be sold for the full value of both mortgages, and both lenders can be paid off in full. However, if the housing market has softened and the property can't be sold for at least $240,000, plus the realtor's fee (typically 6 percent) and other closing expenses, the second mortgagee may have to settle for less than the full amount of his loan.

Let's say that when you took out the second mortgage you weren't too pessimistic about your financial situation and you decided just to take out an 85 percent second mortgage (for $68,000). Now, a year later, your business hasn't improved, and that $68,000 wasn't sufficient to solve all your financial problems. You still have outstanding debt. However, let's assume that since you took out the second mortgage, the housing market has really spurted ahead, increasing the value of the property to $280,000, leaving a remaining equity in the property of $52,000. You may be able to take out a third mortgage against the property, but generally from a private lender. Alternatively, you may be able to refinance your first or second mortgage.

On the other hand, the market may not have moved much in the last year, though the prospects for future years look fairly good. If your poor credit situation is known to the credit rating agencies, your credit score may already be too low to borrow from the conventional lending institutions. In this case you may still be able to find a private lender who's prepared to lend against the potential increase in the equity in your property.

Hard Money Loans

Loans from private lenders on property you already own are called *hard money loans*. These loans are made by private individuals and small local companies who make loans to the desperate and needy, the same way regular banks and brokers service traditional customers. They're harder to find than mainstream lenders and these loans don't come cheap, but they can help desperate borrowers make bad situations better. And sometimes they may be your only choice.

Hard money lenders are private investors who, if the interest rate is high enough and the perceived risk low enough, will put up the money. Brokers and other intermediaries who arrange hard money — or private money — loans go to people who have money to lend, and match them up with people who can't get money any other way.

If that sounds a little like how the Mob works, don't worry. Hard money lenders aren't loan sharks who break borrowers' kneecaps when they can't repay. At the same time, these lenders aren't your Granny Sue either. They charge interest rates and fees that would make conventional borrowers cringe. Generally, they base their lending decisions upon whether or not there'll still be enough equity in your property that they'll be able to foreclose, if necessary, and still turn a profit. Private money fills a niche in mortgage lending, helping people who have specialized needs, or too many credit problems to get conventional financing.

To find private lenders, ask Realtors who are active in your community. The classified section of your local paper probably includes ads placed by investors who are prepared to make hard money loans. You can also do a quick search of the internet for hard money loans. You're sure to find a private lender who's active in your community.

Private loans usually have a short fuse. Even though the loan payments may be amortized over a 10-year period, the loan is probably due and payable in three years. The rate will usually be significantly higher than you'd like to pay, but these are desperate times for you. These loan arrangements are created by desperate debtors on the one hand, and those who think they can make a killing with the proceeds on the other. They make the loan knowing full-well that you may ultimately default on the loan. Then they can relieve you of the property and take full advantage of its increased value. Some call this the "vulture syndrome." The payoff can be very difficult to handle, especially if your financial position doesn't improve quickly enough, so take out such a loan only with considerable caution.

Hard money loans can be helpful if you have absolutely no other alternative. The loan buys you time but adds another set of entanglements. I can't say this enough: borrowing to pay bills isn't a way out of debt. *It's just substituting one creditor for another and buying you time*, often at a considerable cost.

In the end, most hard money loans are repaid by taking out another loan with an institutional lender such as a bank, when the private loan comes due. Hopefully, the time you've bought for yourself this way will have given you the opportunity to improve your financial situation somewhat. That

FULL EQUITY LOANS

NO.	DESCRIPTION	VALUE
1	ORIGINAL APPRAISED VALUE	$200,000
2	FIRST MORTGAGE, (80% OF VALUE)	$160,000
3	EQUITY	$40,000
4	NEW APPRAISED VALUE, AFTER 2 YEARS OF OWNERSHIP	$240,000
5	NEW EQUITY AMOUNT	$80,000
6	SECOND MORTGAGE, (85% OF NEW APPRAISED VALUE)	$68,000
7	REMAINING EQUITY	$12,000
8	NEW APPRAISED VALUE, AFTER 3 YEARS OF OWNERSHIP	$280,000
9	NEW EQUITY AMOUNT	$52,000
10	PRIVATE LENDER THIRD MORTGAGE	$52,000

TOTAL OF THE 1ST, 2ND AND 3RD MORTGAGES IS $280,000, WHICH EQUALS THE NEW APPRAISED VALUE OF THE PROPERTY. CONSEQUENTLY, IF YOU HAVE NO EQUITY YOU HAVE NO INTEREST IN THE PROPERTY, IT'S JUST A PLACE TO LIVE!

Full equity loans
Figure 2-3

refinancing almost always requires a loan against some other real property that has available equity.

To the contractor who's on the ropes, taking out a third mortgage for the full remaining equity or even the future potential equity in the property is essentially the same as selling the property — you still own the title at this stage, but the property has no actual value to you. The full value has been taken out of the property. See Figure 2-3.

The Condition of the Property Market

If the market softens, the holder of the third mortgage will be in a very precarious position. If you default and the property is subject to a forced sale, the first, and probably, the second mortgage holders will get paid from the proceeds of sale. But if the property value has dropped significantly due to the sacrifice sale, the third mortgage holder will be wiped out. He essentially gets nothing. That's the risk he's taking and why he needs a high interest rate and fees to justify the risk.

However, if the housing market continues strong, and the property continues to appreciate in value, there may still be some equity left if it has to be sold at a later date. If you can hang onto the property, you're now building equity. This could be useful in the future as the security for a new conventional loan when your credit situation has improved.

When you're taking out a second or even a third mortgage, everything depends upon the future of the housing market, and that isn't always easy to judge. Though the market has remained strong for many years, there are now signs that the housing "bubble" may be about to burst. So, second, and particularly third, mortgages may be much more difficult to obtain in the future. But if you need cash in a hurry, they're another place to look, after liquidating your available assets and factoring your receivables.

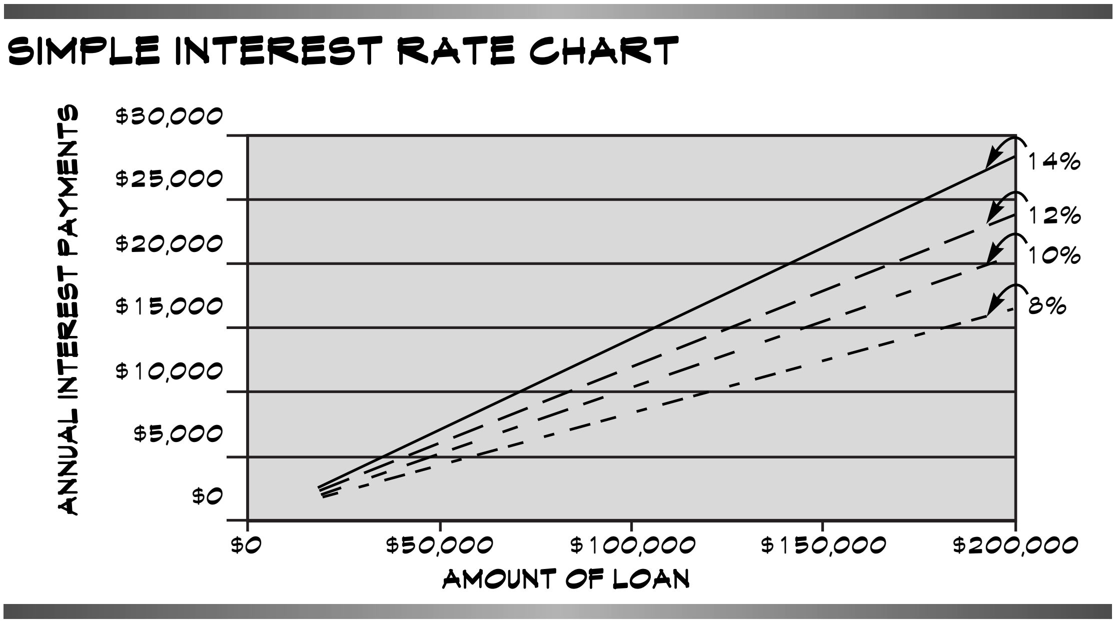
Your credit rating makes a big difference when taking out any loan, as we discussed earlier. *So make sure you know your credit score and protect it*, by making sure that everything in your credit record is accurate. If you find any problems in your record, take aggressive steps to correct them. If you foresee needing a loan in the future (as you almost definitely will, even in the best of circumstances), make sure your credit score is as high as it can be. And take out the loan before your financial problems become acute; certainly before your credit problems reach the national credit reporting agencies.

Remember, when you borrow money to pay your bills, you're not reducing debt. You're just swapping creditors. Every swap costs you money for an appraisal, title search, loan fees, and document recording, not to mention the interest. Don't add to your debt burden unless it's absolutely necessary. And when you do borrow, be sure to have some predictable income source that will meet the monthly loan payments — the lender will insist on this anyway. Otherwise, all you're doing is trading creditors. There's no advantage to that. Worse, you run the risk of adding one more black mark to your credit record.

Occasionally you'll get a property appraisal that's way too high. It's happening more frequently as there's pressure on appraisers from a number of quarters to inflate their appraisals or risk losing appraisal business. Appraisals at 125 percent of the true value of the property do occasionally happen. If it happens to you, your bank may be prepared to lend you 100 percent of the true market value of the property (since that's still only 80 percent of the inflated appraisal), either by refinancing the first mortgage or by adding a second mortgage. But note that this doesn't actually increase the true equity you have in the property, just your ability to borrow more money.

Buying Time

We've already mentioned that loans, even though they have the significant disadvantage of increasing your debt load rather than reducing it, do have the distinct advantage of enabling you to buy time. And the word "buy" is very appropriate here, as you pay a lot for the time that you gain for yourself. So let's look at the effect the cost of loans has on your financial situation.



Simple interest rate chart
Figure 2-4

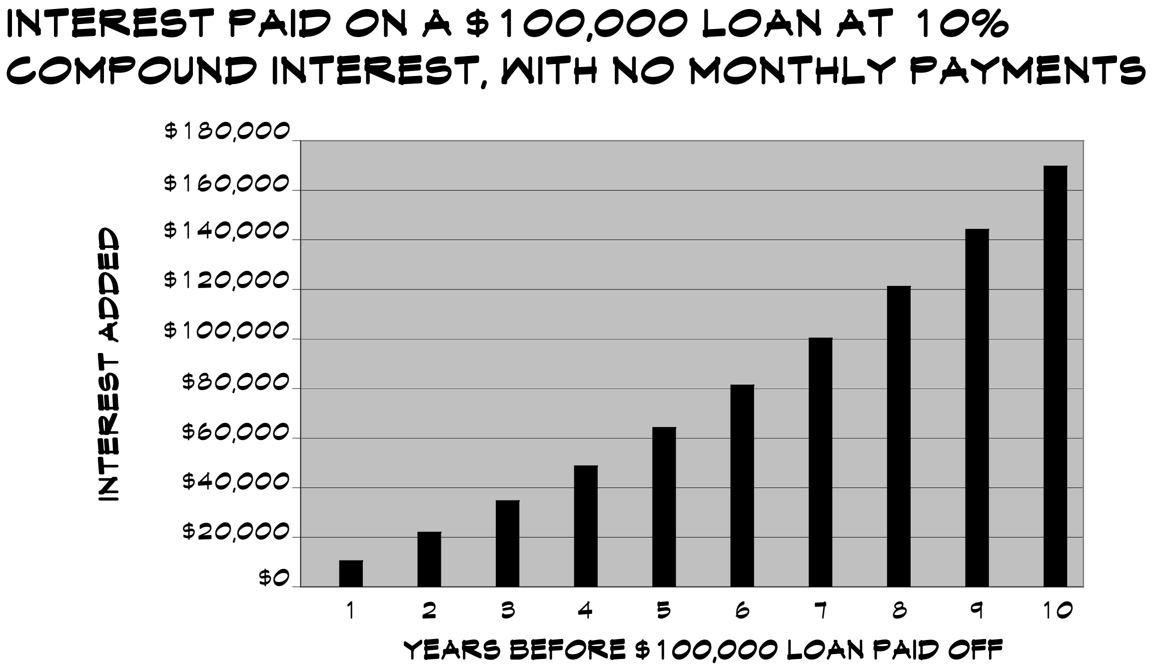
Interest

Interest payments are the price you pay when you borrow money to give yourself the time to climb out of debt. Figure 2-4 is a simple interest rate chart. Let's say you want to borrow $100,000 to pay creditors that you need to keep happy, as they supply essential items you need to keep your business running. If you borrow at a 10 percent interest rate, you'll increase your total debt by $10,000 annually (at simple interest), until you've paid off the loan, assuming you don't make any interest payments.

The money you borrowed allowed you to pay off your creditors, but now you'll have an upset banker on your hands if you can't make the loan payments on time. Also, you're $10,000 (at simple interest) deeper in debt than you were before. And that's if you were able to borrow at a relatively modest 10 percent interest rate. Look at the chart again. At 12 percent, you're going to be $12,000 deeper in debt, and at 14 percent you'll owe $14,000 more. And if you were to borrow $200,000 at 14 percent, you'd be a whopping $28,000 further in debt, and that's just for the first year of the loan.

Compound Interest

However, most lending institutions will charge you interest at *compound interest* rates rather than simple interest, because if you don't pay the interest each month they charge you interest on the previous month's interest. If you want to borrow $100,000 at 10 percent interest, after one year, compound interest will have added a new debt of $10,427 as opposed to the $10,000 simple interest would have added, if the interest is compounded

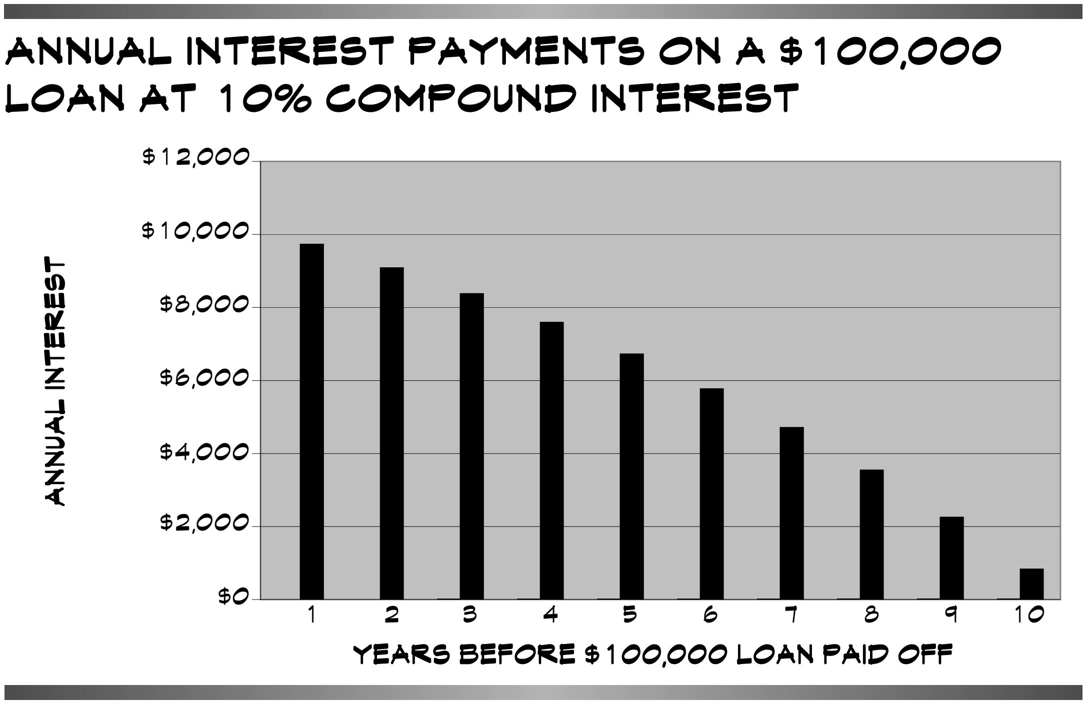


Interest paid on a $100,000 loan at 10% compound interest, with no monthly payments
Figure 2-5

monthly and you can't keep current with your payments. So you're now $110,427 in debt.

Now let's take this newly created $10,427 debt plus the original $100,000 loan and project the additional interest added over a 10-year loan. Figure 2-5 shows how debt increases at compound interest rates, assuming you don't make any payments on the loan or the interest. After five years of compound interest, you've added $64,205 more debt than you started with and now owe $164,205. After 10 years of compound interest and no payments, you've added $169,632 to the initial loan for a grand total of $269,632. That's extremely expensive, and certainly no way to get out of debt.

No lending institution is going to allow you to borrow $100,000 and make no payments on the loan for 10 years. So let's assume that you pay off the loan by making monthly payments on the principal and interest, and we'll calculate how much you'll have paid for the privilege of using the bank's money. The length of time you select for the loan will depend upon how much you can afford to pay each month. The longer the time period you select, the less you have to pay off each month, but the more you'll end up paying in total interest. We'll look at it again for each year up to a 10-year loan period. Figure 2-6 shows the interest portion of the $15,858.12 ($1,321.51 per month) annual payments you'll have to make for a 10-year,



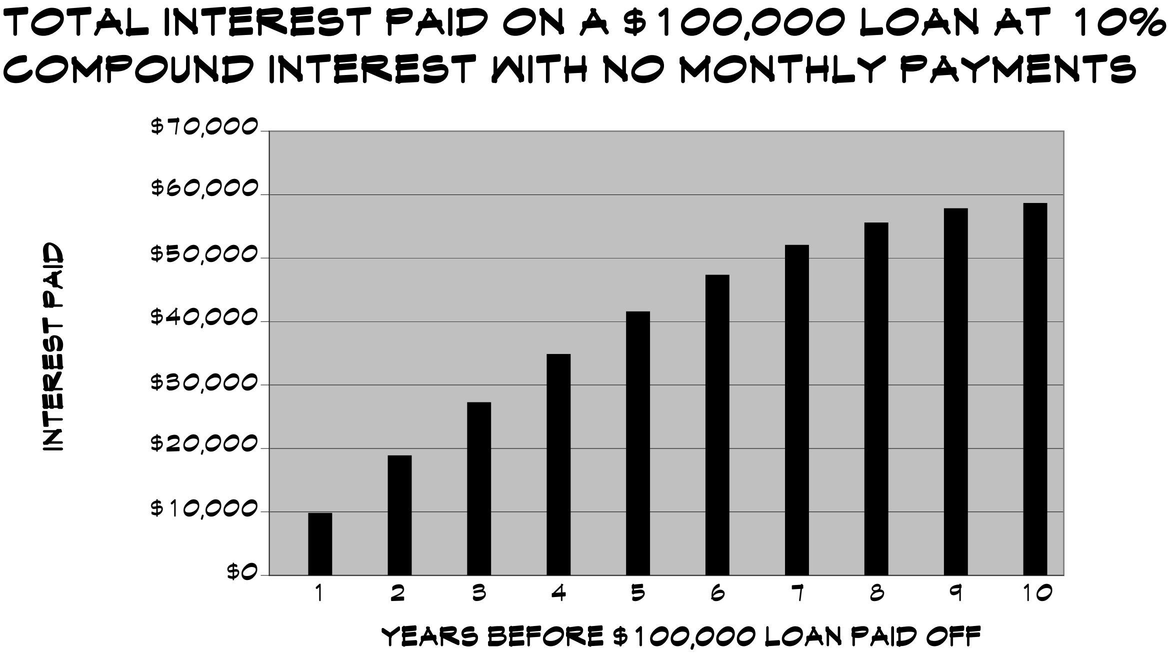
Annual interest payments for a $100,000 loan at 10% compound interest
Figure 2-6

$100,000 loan at 10 percent compound interest, and Figure 2-7 shows the total interest you'll pay for the same loan for the same time periods.

Clearly, it's a trade-off between how much you can afford to pay each month and the total interest that you'll have to pay. If you need to borrow $100,000 to pay off some debts, it's unlikely that you're going to be able to make monthly payments of $8,791 and pay off the loan in one year. If you could, you'd only have paid $5,499 in interest, even at a 10 percent annual interest rate compounded monthly, because the loan amount that you're paying interest on is decreasing rapidly each month.

This should encourage you to push yourself to make the largest monthly payments you can, so you can pay off the loan in six years, with monthly payments of $1,853, paying a total of $33,386 in interest. On the other hand, if you stretch the loan out to 10 years, your monthly payments only drop by $532, to $1,321, but your total interest payments increase to almost $60,000. So your monthly payments have dropped by less than 30 percent but the total interest you end up paying has almost doubled. This also should encourage you to pay off a loan as quickly as possible because *compound interest is a silent killer.*

So, if you have to borrow, do it right. That's the purpose of this section — borrowing from creditors, both willing and reluctant. We've talked a lot about interest compounding and the effect of the time period of the loan, but we haven't discussed one other important factor — the loan application.



Total interest paid on $100,000 loan at 10% compound interest, with no monthly payments
Figure 2-7

Taking Out a Loan

Some lenders deliberately try to make it hard to compare interest rates. They use computation methods that make the rate they're quoting seem more competitive than it really is. Fortunately, there's a single, uniform standard that's prescribed by federal law. It's the Annual Percentage Rate (APR). Don't put too much faith in interest rate quotes that omit those three key letters. Once you have the APR, it's an easy matter to compare loan rates.

If you have to borrow money to buy some time, you'll need to provide some documents — a current Financial Statement or Balance Sheet, a Profit and Loss (P&L) Statement (also referred to as an Income Statement), possibly a Statement of Cash Flows, and your tax returns for the previous two years. The bank will supply its own loan application form.

It's against the law to submit phony documents when applying for a loan. But it's completely legitimate to supply documents that show your financial situation in the most favorable light without actually misstating the facts. Your accountant will be able to suggest some legitimate ways to dress up your assets and de-emphasize your liabilities. But don't carry this too far. Lenders are quick to spot inflated assets and understated liabilities.

Financial Statement

Review the Adjusted Financial Statement in Figure 2-8. Now compare it to the original financial statement from Chapter 1, Figure 1-1.

ADJUSTED FINANCIAL STATEMENT FOR LENDER

NAME: TWICE RIGHT CONSTRUCTION **DATE:** 05/06/07

No.	ASSETS	AMOUNT	No.	LIABILITIES	AMOUNT
1	CASH IN BANK	$3,100	1	VALLEY LUMBER	$50,220
2	LOANS DUE YOU	$2,450	2	ABCO PLUMBING	$55,170
3	INSURANCE POLICY VALUE	$2,550	3	JOHNSON ELECTRICAL	$39,740
4	RECEIVABLES	$109,590	4	PHILLIPS HEATING	$71,960
5	CURRENT CONTRACTS	$343,970	5	CURRENT CONTRACT COSTS	$30,950
6	INVENTORY	$77,400	6	CREDIT CARDS	$10,690
7	REAL ESTATE	$175,000	7	IRS	$55,880
8	AUTOS AND EQUIPMENT	$34,600	8	EAST BAY SAVINGS	$257,880
9	OFFICE FURNITURE	$32,670	9	SOUTH FEDERAL BANK	$147,550
	TOTAL ASSETS	$781,330		**TOTAL LIABILITIES**	$720,040

NET WORTH = $781,330 – $720,040 = $61,290

Adjusted financial statement for lender
Figure 2-8

Include in your Assets all cash, loans due to you, insurance policies, receivables, inventory, real estate (land or remodeling units), tools and equipment, office furniture and equipment and any other items of significant value. Generally, you can exclude those loans from relatives and friends that are moral obligations rather than legally enforceable debts. On the Liabilities side, make sure to include all secured debts. These debts are recorded with the state or county where you live and will show up in a credit check.

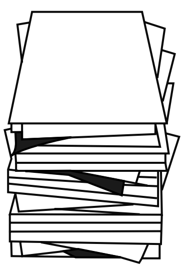
You'll notice that in adjusting the statement from Figure 1-1, on the Assets side, we've stated the full amount of your receivables and your ongoing contracts, even though some of the payments may not yet be due. On the Liabilities side, we've done the reverse, and rather than showing the full amount of the liability, we've only shown the amount of the liability that's presently due. This gives us the Financial Statement in Figure 2-8. We've increased net worth as much as possible, which now shows a value of $61,290. That's still not great, but at least it's positive.

This method of adjusting the financial statement avoids showing debts that you know are coming, but aren't really due yet, and also shows the full amount of receivables that will eventually be collected on outstanding jobs even though some of the amounts are not yet strictly due. If possible, head off any new billings from creditors until the bank has completed the processing of your new loan application.

This type of manipulation is not strictly kosher under GAAP and SEC (Securities and Exchange Commission) reporting rules, in which the Financial Statement would be presented as a Balance Sheet. This is a statement of your financial situation at one moment in time. Of course, that moment in time should be the same moment in time for both the Assets and the Liabilities side of the equation. See Chapter 6.

You'll use the Adjusted Financial Statement in your loan application if the bank will accept it, together with a Profit and Loss Statement and your last two years' tax returns.

You may ask yourself, why are you applying for a loan in the first place, since you're now showing that you have a positive net worth? Well, the reason is clear if you look at the top line of your financial statement. You have very little cash available, and it's not sufficient to pay your outstanding bills and upcoming salary checks. All your money is tied up in inventory, receivables and ongoing contracts. So you need a loan to pay current bills.



You'll then need an Income Statement to go along with your Financial Statement. Unlike a Financial Statement (or a Balance Sheet), which is a snapshot in time of your financial situation, an Income Statement is a record over a period of time of the income and expenses of the business, and what's left over after expenses are subtracted from income. Clearly, if that's a positive number you made a profit, but if it's a negative number you incured a loss for that time period. It's typical to show an Income Statement for the last year of operation, so that's what you'll do.

Income Statement

So what should an Income Statement look like? You'll find various formats, depending on which accounting text you consult, but they'll all have pretty much the same bold headings; only the sub-headings will be different. I've shown a typical Income Statement, Figure A1-4 in Appendix 1, which you can simply copy, or you'll find an Excel version on the CD accompanying *Contractor's Guide to QuickBooks Pro,* published by Craftsman Book Company. Figure 2-9 shows an Income Statement for our fictitious company, Twice Right Construction.

You'll see that for all the work you did last year, the company made the grand total profit of $26,040 — not very impressive (only just over 2 percent of gross sales); no wonder you need to borrow money to pay your outstanding bills. But at least it's positive, and you paid yourself a reasonable salary ($65,000), so things weren't all bad. Now you just need to decide what to tell the bank's loan officer you're going to do to improve the performance of your operation. He'll need to be convinced that you can get this profit number up sufficiently to make the payments on the loan you're requesting.

INCOME STATEMENT

NAME: TWICE RIGHT CONSTRUCTION PERIOD: 5/07 - 4/08

GROSS SALES		$1,204,755
CONSTRUCTION COSTS		
LABOR	$391,935	
MATERIAL	543,965	
EQUIPMENT	27,740	
SUBCONTRACT	116,290	
TOTAL COSTS	$1,079,930	
GROSS PROFIT FROM CONSTRUCTION		$124,825
OTHER INCOME: INTEREST FROM INVESTMENTS		$2,740
ADJUSTED GROSS INCOME		$127,565
OVERHEAD		
MANAGEMENT SALARY	$65,000	
ESTIMATOR/PROJECT MANAGER SALARIES	0	
CLERICAL SALARIES	22,780	
OFFICE EXPENSES	4,680	
LEGAL, AUDIT, MISCELLANEOUS	3,375	
EQUIPMENT NOT COSTED TO JOBS AS EXPECTED	5,690	
TOTAL OVERHEAD COSTS		$101,525
PROFIT (LOSS) BEFORE TAXES		$26,040

NOTES:

1. ALL LABOR COSTS INCLUDE FRINGE BENEFITS AND TAXES.
2. EQUIPMENT OVERHEAD COST REPRESENTS TOTAL COST LESS $'S CHARGED TO JOBS (UNUSED TIME).

Income statement
Figure 2-9

"...you're going to have to work harder and get paid less, but that's the price you have to pay to get yourself out of debt."

If you're going to ask for a $100,000 loan, which seems reasonable, over a five-year period, at 7 percent, it will cost almost $2,000 per month or $24,000 per year. Where are you going to find that amount of cash each year to pay off the loan?

Here are a couple of suggestions. Take a pay cut of $5,000 to show that you're prepared to sacrifice to keep the ship afloat. Then look at that subcontract figure of $116,290. You're a skilled electrician, so by getting out of the office 25 percent of the time, you'll save $20,000 by doing some electrical work yourself. So there's $25,000 a year you've saved straight away.

Yes, you're going to have to work harder and get paid less, but that's the price you pay to get out of debt. And remember, you're just borrowing money, which doesn't actually pay off any debts; it only buys you time to improve your operation. Then you should be able to get that annual profit number up enough to pay your bills with some of the profits you're making.

One other advantage of you doing some of the electrical work is that it will allow you to move 25 percent of your salary from overhead to the labor line in the construction cost section. Since you're reducing your salary by $5,000 and moving $15,000 to labor cost, this will reduce your overhead, currently running at 9.2 percent ($110,525/$1,204,755), to 7.5 percent (($110,525-$20,000)/$1,204,755). Consequently, the overhead you add to your estimates will be significantly lower and make your bids more competitive. Altogether, that gives you quite a good case to make to your loan officer.

Security

Before the bank will consider giving you a $100,000 loan they'll need to know what you're going to offer them as security against defaulting on payment over the next five years. So go back to your Financial Statement and see what assets you have that you can put up as security for the loan. That item #7, real estate, worth $175,000, looks like a very good candidate, so that's what you should offer to secure the loan.

Loan Application

Have your accountant prepare the Financial Statement and the Profit and Loss Statement. That way they appear to come from a neutral party. But the statement doesn't have to include an auditor's opinion. That's a waste of time and money unless you're running a publicly-held company.

The tax returns you submit with your loan application are assumed to be the same returns you filed with the Federal and State governments. But there's no way for the bank to check that. They have to take your word for it. I certainly wouldn't condone it, but some contractors have been known to prepare one return for filing with the IRS and another for loan applications. The second return shows the highest possible income that can be justified, as compared to the IRS return which shows just the opposite. The second return increases taxable income by minimizing deductions and including every penny of cash income from overtime or small jobs done for cash.

Who decides whether you get the loan? As you might guess, it's a committee. All banks have loan committees that decide who gets loans and who doesn't. The committee's role is to protect depositors and shareholders in the institution, and to allocate money among creditworthy borrowers. But you'll probably never meet with the loan committee. Instead, you'll work with a loan officer whose role is to prepare the paperwork and make a recommendation to the committee on the loan.

Some loan officers will tell you what the loan committee is looking for in financial statements and tax returns. They know what the committee will approve and what they'll scrutinize closely. If your loan officer suggests ways to put your application in the best possible light, follow that advice. The loan officer doesn't want to waste the committee's time on applications that won't be approved any more than you do, especially if one of the members of the committee is his boss. So he only wants to present loan applications to the committee that will show him in a good light.

"Who decides whether you get the loan?"

You've now done all you can to raise a loan from the bank, so keep your fingers crossed and hope for the best. If the bank turns you down, there are numerous other lending institutions that are dying to lend you money. You probably get two pre-approved credit card applications in the mail almost every day, so there's no shortage of lenders, just a shortage of low interest lenders. So it's up to you to assess how desperate your situation is and how much interest you're prepared to take on in order to pay off your current bills. But before you borrow from high interest lenders, be sure you'll have the means to pay off these high interest loans in the future. Otherwise you're just making your situation worse. It's a matter of balancing the availability of cash now against the time it gains you to get your house in order.

Credit Cards

Your recovery will take time. Getting enough time may require the use of every source of cash at your disposal. A major source of cash that you can't afford to overlook is *plastic money*; the credit cards in your wallet. Think of your credit cards as pre-arranged lines of credit that you can draw on as needed. However, remember, using cash to pay bills only lets you go down to broke. When it's gone, it's gone. Using plastic lets you go below broke, all the way into tomorrow's income.

You can withdraw cash against most major credit cards. Use this money to pay past-due materials bills. The more credit cards you have, the more credit you can draw on. Stay within the credit limit on each card, and make the minimum monthly payment on each for as long as possible. But don't use this credit if money is available from other sources. Try to stay above broke. The balance due on your credit card will carry a compound interest rate that's among the highest charged for all loans, often in excess of 20 percent.

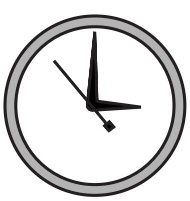
Stalling

If you've reached the credit limit on every card you have and you can't make all the minimum monthly payments, it's time to stall. That's a simple maneuver. You put off an obligation for an undetermined length of time with a promise. It involves no cash payment on your part.

Promise your creditors that your condition is only temporary. Assure them that it's the result of events beyond your control. Use every excuse that seems appropriate, but be as truthful as you can. After all, you want to come out of this with your dignity, self-respect and believability intact.

If all else fails, tell the unvarnished truth — you're a poor business manager. Explain that you understand the creditor's problem and are sympathetic. You know he deserves to get paid and you wish you had the money to pay him, but you don't. You'll certainly understand if he decides to sue you. But if he does, tell him you'll transfer him to column three of your creditor list and stop any future payments (remember Figure 1-6 in Chapter 1). Explain that you can probably stall him legally for months or even years because you have no other options. Explain that if enough creditors won't cooperate, you'll be forced into bankruptcy. Then everybody will lose, with the exception of your secured creditors. Here's a rule of thumb — the brokest man is also the most protected man. If you ain't got it, they can't get it!

Chapter 13 of the bankruptcy laws lets you reorganize your debts and put your creditors on hold for three to five years. If that doesn't work out, you can file for Chapter 7 bankruptcy, which discharges nearly all unsecured debts completely. We'll talk more about bankruptcy in the next chapter of the book.



Straight talk will persuade many creditors. They'll take your advice and wait, at least for a while. Others will take a tougher course and sue. In either case, you get more time to recover.

Floating

Another option to consider is your *float*, checks you've written which haven't yet cleared your bank. Nearly all contractors use their float at one time or another. You write a check at the lumberyard, knowing that there isn't enough money in your account to cover it.

But you also know that there *will* be enough money tomorrow morning when you deposit the check you'll get from the Jones job.

Banks help you compound the float. They credit the payee's account when a check is deposited rather than when funds are actually withdrawn from the payer's account. Here's an example. A California contractor deposits a New York check in his California account. He gets credit immediately at his California bank, but the funds aren't withdrawn from the New York account until perhaps two or three days later. At one time the check had to be flown back to New York before a debit was made on the New York account. Both the California contractor and his New York client had use of the same money for two or three days.

However, using modern electronic means, banks are getting much quicker at clearing checks, so you shouldn't rely on the float being available for more than a day or so. But until they reduce the float time to zero, it's an opportunity to use money that doesn't really exist. That's important when you're strapped for cash. Float will buy only a little time, but sometimes even that can help.

Kiting

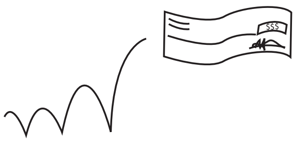
You've probably heard of another possibility for creating a float, called *check kiting*. Check kiting is among the most common and most dangerous forms of check fraud foisted upon financial institutions. A kite is a form of shell game using at least two accounts at separate financial institutions. Allowing depositors to have immediate use of uncollected funds actually facilitates the fraud. Indeed, Regulation CC mandates early access to deposited funds. In the typical scheme, a check is written by the kiter on one account containing insufficient funds and then deposited into an account at another institution. A check drawn on the second account is used to cover the resulting overdraft on the first account. Taking advantage of the float caused by normal delays in the collection system, the kiter creates fictional balances in each account and uses these balances to obtain cash advances.

"Banking is a game of trust."

As one federal court put it, "The ability to write checks against provisional credits gives the shrewd bank customer free use of someone else's money." Viewed charitably, this is called aggressive cash management. It also gives the dishonest customer a chance to write checks against non-existing deposits. When done systematically and fraudulently, it's criminal check kiting. This is a federal offense carrying a penalty of up to *$1,000,000 or 30 years in prison, or both*.

Dealing with Your Banker

Let's get back to the real world. There's no substitute for an understanding banker. A banker who's on your side is an invaluable asset in many ways. Banking is a game of trust. In the good times, you plan for the bad times that may come. You develop a friendship with your banker when



everything's coming up roses. During the good times, borrow a little and pay it back. The amount is up to you. If security is required, use your house, some equipment or a vehicle. Borrow enough so that it involves your banker if you run into trouble. You want him to feel that he has a stake in your survival.

Then, if the time comes that you can't meet a payment, keep your banker fully informed. In Chapter 5, we'll explain why communication with your clients is very important. This goes double for your banker.

If you have an unsecured loan with a bank and you're behind on the payments, offer to convert the note to a longer term secured loan with your car, home equity, receivables or an assignment of sale proceeds as security. This will extend the time for payment for months, or even years.

If you're behind in your mortgage payments and the bank is ready to foreclose, arrange for a quick sale to someone you know well who's in better financial condition than you are. This will stall the bank for the two- or three-month escrow period. Assign the sale proceeds to the bank. Usually your buyer can qualify for the loan and take title with almost no money down.

If you have equipment payments or loans that are past due, you can usually roll over the notes. By that we mean that you can pay only the interest on the loan and sign a new note with a new payment schedule and due date. Basically, you're starting over from scratch on that particular debt. But the bank isn't obligated to do this. They do it as a favor to you, their good customer.

There's another privilege that many banks grant to their good customers. Banks need deposits to make loans. If they don't make loans, they can't survive. A customer who keeps a high four-figure or low five-figure balance in a checking account is a good customer. No bank will close that customer's account just because there's an occasional financial hiccup, nor are they going to bounce that customer's checks. Some contractors with heavy cash flow get away with overdrawing their checking accounts. No bank would boast about something like this, but it happens all the time.

The Tax Man

Many general contractors who get into financial difficulty never actually make it to bankruptcy court. Instead, they get shut down by the IRS. You can't ignore the IRS the way you can other creditors. One of the quickest ways to put your company out of business is to stop making deposits for withheld taxes. But there are a number of other ways to get into tax trouble, also.

There's a penalty for failing to file a tax return, so be sure to file on time, or apply for an extension. But it isn't a crime to fail to pay the amount due. There is a penalty, of course. On your personal tax return, the IRS will charge you 5 percent a month, increasing up to a maximum of 25 percent.

Some lenders charge nearly that much for loans, and those lenders want a credit check and collateral for the loan. The IRS demands neither on unpaid taxes. It's a loan you don't have to qualify for and there's no application form either.

If you're trying to buy time, the IRS bureaucracy is on your side. Unless your problem is assigned to a field agent for personal attention, you could get lost in the IRS computer system for at least a year.

Let's say that you've reported a tax obligation and that the IRS has sent you a demand for payment. Here's a good rule of thumb. If the notice is signed by a computer, put it in a drawer. Nothing serious is going to happen until your file's been assigned to an IRS agent in a local field office. When that happens, you'll know it, because the notice will be signed by hand. Then it's time to take it seriously, but in the meantime, you've bought yourself a year of grace, albeit at a hefty interest rate.

There's only one scheme I've ever heard of that might beat the IRS out of their money. I don't recommend it, but here it is, for your reference. Take every dollar you have out of banks and credit unions. Sell your home and all real estate. Shut down your construction business. Don't work for any employer that reports your income to the IRS. Convert all your assets into something like copper wire that can be put into storage until the IRS matter is settled. Although you won't be drawing interest on money in the bank, the copper wire will probably appreciate as quickly as inflation erodes the value of the dollar. *In other words, go entirely broke!*

The Utility Companies

It's hard to run any business without electricity, water and a phone. Eventually, you'll have to pay your utility bills. But it's easy to postpone that date far longer than you might expect. First, use all of the time they allow before they tell you your service is going to be terminated. When that time has run out, phone the utility company and ask for an extension. Most utilities will postpone the cutoff date by two weeks if you promise payment by that date. If they won't give you two weeks, ask for ten days or one week. When that time has passed, call again and ask for a two- or three-day extension. You should have no trouble getting at least one more 48-hour extension. When the "shut-off" man arrives at your door, write him a check for the minimum amount needed to continue service, even if there isn't sufficient funds in the account to cover the check.

Paying your utility bill at a local merchant who has been designated to accept payments will give you a few additional days. Utility company-approved payment locations usually take three to five days to get the paperwork and receipts to the utility office. The utility will consider your payment made at that office even if they haven't seen your check yet. Your check will take another four to six days to bounce twice through your banking system. The utility will then ask you to make the check good in cash. Plan to be unavailable for two or three days. When you finally talk to them, begin again with a series of requests for two-week, one-week, 48-hour and finally 24-hour extensions. These requests should be honored because you're dealing with a different department this time.

"Most utilities will postpone the cutoff date by two weeks if you promise payment by that date."

Eventually, you'll have to come up with the cash. But using the method described above should buy you at least four weeks of delay. That's like getting a four-week loan at zero interest. This is no way to treat your suppliers, and not something I'd recommend, but if these are desperate times for you, you may have to resort to this type of tactic.

Incidentally, I've found that the telephone company won't give you as much time as the utility companies. Phone companies can disconnect you at their office. They don't have to send out a service truck as the utility companies do.

If necessary, you can use this procedure every 90 days or so without too much adverse effect on your credit rating. If you have to do it every month, your credit rating should hit rock bottom in about three months, making it tougher each month to get an extension.

Summary

Finding money and buying time are the two most important matters you'll need to address as soon as you find that you're unable to pay your outstanding bills. You can leave how you got yourself into this mess until later. The first places to look for money are the assets that you presently have and the outstanding receivables that you haven't been able to collect but can probably factor.

Then look at the many options there are for borrowing money. However, borrowing money doesn't pay off debts. It only buys you time — and at a price. If you're borrowing to buy time, you'll need a current Financial Statement, a Profit and Loss Statement, and your tax returns from the previous two years. And you'll generally need some security to offer against the possibility of you defaulting on the loan, if you're going to get a reasonable interest rate.

Liquidating your assets, borrowing against real estate, and factoring are all options potentially available to you.

When you've exhausted your borrowing capacity with the conventional lending institutions, there's always the hard money lender you can go to, but be prepared to pay very high interest rates and high arrangement fees.

You can also buy time with credit cards — which are actually pre-arranged loans — but at the expense of very high interest rates. Stalling and floating are other techniques you can use to buy time if you've run out of options. You can even buy time from the IRS by failing to pay on time the taxes you owe. But even if you don't pay on time, be sure to file your tax return on time or there'll be a very hefty penalty to pay. None of these approaches are by any means ideal, but in your situation you may have to consider them.

It's in your best interest to develop a good working relationship with your banker. During good times, borrow money and pay it back. This makes sure credit will be there when bad times come around. Dependability and profitability are the keys to managing cash flow.

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Got That Sinking Feeling?

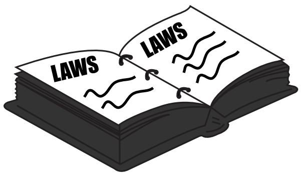
You've exhausted your borrowing capacity and stalled as much as you can. But outstanding bills remain unpaid and more keep piling up. Now you may have to consider bankruptcy as the only way out of your problems. This chapter is going to explain the bankruptcy procedure. But once we've looked at that option, we'll explore other ways to get you back on your feet without going through the trauma of bankruptcy.

Bankruptcy and the Legal Process

When considering bankruptcy, it's important to keep a sense of perspective and be as unemotional about it as possible. Bankruptcy is no longer the absolute disaster that it once was. The name comes from the Italian Renaissance practice of physically destroying a merchant's trading bench if he was unable to pay his debts. This was called Banca Rotta, from which we get the modern term "bankruptcy." In Dickensian times things could be even more brutal. There was little concern for the welfare of other people, especially people who owed you money. The penalty for not paying your debts could be debtor's prison or even a death sentence.

Fortunately, times have changed and modern bankruptcy laws are generally designed to obtain the most favorable outcome for both the creditors and the debtor. All parties generally accept that the bankruptcy laws are fair. They take away the somewhat competitive aspect and make the debtor and the creditor work together to save both parties as much money as possible.

The bankruptcy laws are complex and constantly changing, so you'll need professional advice to proceed along this course. The new bankruptcy law requires that, if you're considering bankruptcy, you must first undergo professional credit counseling. The main purpose of this is to deter as many potential bankruptcy applicants as possible. And if a bankruptcy application is approved, the counselor will steer you towards applying for Chapter 13 (or Chapter 11) rather than Chapter 7 bankruptcy.



The three major parts, or chapters, of the bankruptcy laws that you'll need to know something about are Chapters 7, 11 and 13. Let's look at them briefly, in reverse order.

Chapter 13 of the Bankruptcy Law

Chapter 13 is a reorganization bankruptcy. With this type of bankruptcy, the court appoints a trustee to ensure that the debtor repays his creditor(s) from future earnings. Usually the court, the creditor(s), and the debtor, in that order of priority, will decide on a repayment plan that can last anywhere from three to five years.

Chapter 13 may be one of your better options when it comes to bankruptcy, since it offers you the chance to hang onto your assets, such as a house or property, instead of having to liquidate them, as may be necessary with Chapter 7 bankruptcy. So this type of bankruptcy, though serious, is generally less detrimental to your future than other types of bankruptcy.

The stipulation with this form of bankruptcy is that it's only an option for individuals or businesses that have regular income. In order to file for Chapter 13 bankruptcy, the debtor must have enough steady income each month to pay ongoing business expenses, personal living expenses, and make payments on a debt repayment plan.

Chapter 13 bankruptcies most often come into play when a small contractor or homeowner has fallen behind on his mortgage(s), loans and bill payments, but is looking for a way to pay back his creditors without having to forfeit his assets. Chapter 13 can temporarily halt foreclosure in this situation, because the bankruptcy court will order an *Automatic Stay* once the bankruptcy filing has been entered. This prevents creditors from fully collecting on their debts for a period of time. The person in debt can use this time to catch up on payments based on a pre-arranged schedule. However, if the debtor falls behind in making these scheduled payments and is unable to catch up on missed payments during this time, he'll be subject to foreclosure.

Chapter 11 of the Bankruptcy Law

For the purpose of this book, we consider Chapter 11 to be the same as Chapter 13, except that it applies primarily to corporations and partnerships. A number of the major airlines have filed for Chapter 11 bankruptcy in the last few years. Chapter 11 gives the organization in debt one last chance to get their finances in order. The hope is that the business will reorganize, recover and, as a result, creditors will be fully repaid.

Like Chapter 13, Chapter 11 is classified as a *reorganization bankruptcy* but, in this case, the debtor is typically allowed to propose a plan of reorganization and repayment, so business can be kept alive while paying off creditors over time. The court and the creditors must agree to the reorganization and repayment plan in order for a Chapter 11 bankruptcy to proceed.

Chapter 7 of the Bankruptcy Law

Chapter 7 is quite different from Chapters 13 and 11. It doesn't allow for or insist upon (depending upon which side of the debtor/creditor fence you're sitting) a reorganization and repayment plan. Instead, assets will be seized in order to pay off creditors. Chapter 7 bankruptcies have become quite popular in recent years — there are close to two million filings in the U.S. a year. However, this type of bankruptcy should really only be considered (and with recent changes in the law will only be permitted by the court) if there's just no realistic way that you can hope to pay off your creditors in the allowable three- to five-year period of a Chapter 13 bankruptcy.

"Chapter 7 bankruptcy protects your personal belongings and your means of making a living..."

Though filing for Chapter 7 bankruptcy may seem like a disaster since many of your assets will be forfeited, many debtors are actually quite thankful that it exists. Chapter 7 bankruptcy protects your personal belongings and your means of making a living, allows you to walk away from your outstanding debts, and lets you get your life back together again, without your creditors continually harassing you.

If you decide that you have no choice but to file for Chapter 7, here are the six things that you'll need in order to have everything in place for a successful petition to the bankruptcy court. Not getting all these things together can lead to an unncessary loss of assets.

1) List of creditors
2) Schedule of assets and liabilities
3) List of exempt property (we'll address this in a moment)
4) Schedule of current income and expenditures
5) Financial statement
6) Statement of intent regarding debts secured by property

After you're done, you'll have to think about what assets you're going to have to surrender (i.e. non-exempt items). You'll want to hang onto your personal belongings and benefits (or at least as many as you possibly can). Therefore, your decision as to whether or not to file for Chapter 7 bankruptcy will depend to some extent on how many of your assets you're willing to surrender, if you're unable to hide them. This can be a brutal decision, but it's one you're going to have to make if you file for Chapter 7.

You're probably anxious to know what's generally exempt from surrender. This may vary slightly from state to state, but the list of items which are exempt is fairly similar no matter where you live:

- Motor vehicle, including those needed for your business (to a certain value),
- Tools and equipment needed to carry on your business (to a certain value),
- A portion of unpaid but earned wages or contract receivables,
- Part of the equity in your home (see Homestead section below),
- Reasonably necessary clothing (no mink coats),
- Reasonably needed household furnishings and goods (the second TV may have to go),
- Household appliances,
- Jewelry (to a certain value),
- Personal effects,
- Life insurance proceeds, cash or loan value (to a certain value),
- Pensions, 401Ks and IRAs,
- Public benefits (welfare, Social Security, unemployment compensation) accumulated in a bank account.

Examples of items you typically must surrender (non-exempt property) include:

- Business assets not essential to the continuation of your business,

- Cash, bank accounts, stocks, bonds and other investments,
- Second personal motor vehicle,
- Second personal or vacation home,
- Expensive electronic equipment,
- Expensive musical instruments (unless you play professionally),
- Expensive jewelry,
- Stamp, coin and other collections,
- Family heirlooms of significant value.

After you've made the decision to file for Chapter 7 and drawn up your non-exempt list, you'll turn over all these items to a trustee who's impartial and appointed by the court. Then you get the *order of relief*. This gives you an automatic stay which prohibits your creditors from hounding you. Now you can't be required to pay anyone until your bankruptcy proceeding. You've officially filed for bankruptcy so you're now in the hands of the court.

The court will set up a 341 meeting, and your creditors will ask you how you plan to pay them back. It also gives your creditors the opportunity to challenge your list of exempted items. Of course, you'll have listed as few of your assets as non-exempted items as you think you can get away with. Ultimately it's up to the bankruptcy judge to decide which items on your exempt list are fair and reasonable. Your creditors have 30 days to object to your exempt list. They have 90 days to assess how much you owe them. The court will mediate this process as well, and you can bet your creditors won't miss that deadline. Finally, the trustee of the court will decide how to disperse your non-exempt assets to your creditors, in partial payment of your debts, and — you're off the hook.

"...a bankruptcy law was passed in 2005 making it much harder to file for Chapter 7 bankruptcy..."

Maybe Chapter 7 bankruptcy doesn't sound so bad after all, since it does give you the chance to purge all of your outstanding debts, albeit at a significant cost in assets and self-esteem. Chapter 7 bankruptcy has become quite popular in recent years, because it allows poor and middle-income people with large debt on numerous credit cards, multimillionaires, and those operating outside the law (who hide most of their assets,) to file for Chapter 7 and walk away, leaving their creditors with almost nothing.

As I mentioned earlier, after an almost eight-year battle in Congress, a bankruptcy law was passed in 2005 making it much harder to file for Chapter 7 bankruptcy, and forcing most filers into a Chapter 13 or Chapter 11 repayment filing. An *income means* test was instituted, setting an annual dollar income figure above which you're not permitted to file for Chapter 7. Filers with incomes above their home state's median income, who the court decides can afford to pay at least $100 per month over five years (that's $6,000), will be forced to file for Chapter 13 bankruptcy, with the judge deciding on a repayment plan. However, if you don't have sufficient assets, or if your income is below your state's median income, upon approval by a judge, you'll still be allowed to file for Chapter 7, which will erase all your debts after your non-exempt assets have been forfeited.

So what's your state's median income? Well, the median income for the U.S. as a whole in 2006 was $56,862, and ranged from $40,917 for Mississippi at the low end, to $67,084 for Alaska, (due to the oil revenue distributions to all state citizens), and $75,541 for Connecticut at the high end. So your state's median income is somewhere in between these two extremes, and if your income is higher than that, you'll almost certainly not be permitted to file for Chapter 7.

You're probably in the middle-income category, so a Chapter 7 bankruptcy is probably not a way out of your financial crisis, and you'll have to accept a repayment plan under Chapter 13 or Chapter 11.

Deciding Whether or Not to File for Bankruptcy

If you're deeply in debt and considering bankruptcy, here are some guidelines that should help you decide whether or not to file. The choice isn't as simple as you might expect, since it can be a very personal and highly emotional issue. Your self respect is also a factor to be considered. But these days there *is* life after bankruptcy, so try to keep it as "strictly business" as possible.

After you've emerged from bankruptcy, either by having all your debts purged by a Chapter 7 proceeding or having paid off your debts through a Chapter 11 or 13 bankruptcy, you're a valuable member of society again, albeit with a past. And since lending institutions are in the business of lending money, and suppliers want to sell products, they'll be happy to do business with you, provided you meet some fairly strict conditions. So try to keep a sense of proportion and see this as an opportunity to re-establish a future for yourself. After all, it ensures that you'll have a second chance at running your own business. Bankruptcy laws give you the opportunity to learn from your mistakes.

So with this temporary boost to your self-esteem, let's consider whether or not you should be considering bankruptcy at this time. You may be a candidate for Chapter 13 or Chapter 7 bankruptcy if you can answer these questions in the affirmative:

1) The first consideration must always be your mental and physical well-being. Are your debt problems making you genuinely ill — not just upset?

2) Are the bulk of your debt problems (at least 75 percent) caused by the condition of the market — and therefore beyond your direct control?

3) Are you indebted due to the actions of others? Partners, for example?

4) Are your debt problems sucking up the assets of others? Assets you didn't accumulate? For instance, a new wife's assets from a previous marriage, or an inheritance?

5) Are your debts so extensive that there's no way you can see yourself being able to pay them off in a five-year period?

If you answered yes to any of these questions, you're probably a good candidate to apply for bankruptcy. So which form of bankruptcy should you apply for?

Chapter 13 or Chapter 7 Bankruptcy?

If you really have no alternative but to file for bankruptcy, the next thing you'll have to decide is whether to file for Chapter 13 or Chapter 7. As I mentioned earlier, Congress has made it much more difficult to file for Chapter 7 bankruptcy, so that decision may have already been made for you, but let's assume that you still have a choice. Essentially the two factors you have to think about are:

1) Are the debts you're facing overwhelming and you can't see them ever being resolved? In this case you should file for Chapter 7. Alternatively, if you feel they can probably be resolved in three to five years, you should file for Chapter 13.

2) Are you indebted because of legal judgments which you've lost and you can't see them ever being satisfied? If so, you should file for Chapter 7. On the other hand, if you think they can probably be satisfied in three to five years, you should file for Chapter 13.

Let's say you have $100,000 in debts that could be discharged in Chapter 7 bankruptcy. That's probably not enough to make filing for Chapter 7 worth the penalty you'll pay in assets forfeited, though it may make sense to file for Chapter 13. But other circumstances might tip the balance toward filing for Chapter 7.

Suppose you owe the same $100,000 but have been in an automobile accident and are seriously disabled. If you're the major bread-winner or are vital to the running of your operation, and if your disability is going to last for several years, you're a better candidate for Chapter 7 bankruptcy. Remember, an essential requirement of Chapter 13 bankruptcy is that you must have a steady income that will enable you to pay off your debts against a pre-arranged repayment plan. If you're unable to work, that's unlikely to be the case. But if you have continuing cash flow from your construction company and some equity in your assets, even a debt of $200,000 or $300,000 might eliminate bankruptcy as an option.

Use Chapter 7 bankruptcy, if you can, to discharge debts that would take you the rest of your life to pay off. But don't expect to use it for personal gain or to maintain extravagant spending habits. Bankruptcy will change your lifestyle. There's no way around that.

Chapter 7 bankruptcy will do this for you: It will keep a roof over your head, leave you with a living income (albeit minimal), save your automobile, household goods, work tools and a small amount of cash in a savings account. Nearly everything else will have to go, unless it's fully mortgaged and there's no equity in it, or you've been able to hide it with some type of asset protection plan that we'll discuss in a moment.

Chapter 13 bankruptcy puts your creditors in a holding pattern while you work out some sort of repayment plan. But this isn't just a way of stalling your creditors. Chapter 13 bankruptcy is court-supervised and requires the general agreement of most of your unsecured creditors. Secured creditors, those who have a claim on a particular asset (such as through a recorded mortgage on a property), are handled on a case-by-case basis. You have the choice of giving them the security or paying off the debt, if possible, and keeping the security for yourself.

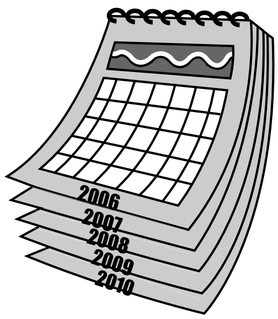
Chapter 13 bankruptcy will buy you time. But the maximum time under the law is typically three years. If your available income won't pay off your debts in three to five years at the very most, it's best to seek protection under Chapter 7. That's often called *straight bankruptcy*. Creditors don't have to agree with the plan, and there are no repayment schedules to meet, as we've discussed.

Bankruptcy Procedure

The bankruptcy procedure is complex, so don't try to handle it without a lawyer. Some books say you can, but I wouldn't advise it. There's much more to it than meets the eye. Find an attorney who handles a volume of bankruptcy matters and watch him carefully to make sure he performs for you. Attorneys are busy people, just like everyone else. Bankruptcy attorneys sometimes have more low-profit work than they can handle. If you expect to move quickly through the maze of legal requirements, be the squeaky wheel that gets the grease.

Here's what to expect if you file for Chapter 7 bankruptcy. First, you'll fill out a detailed bankruptcy petition. This shows all the debts you claim can't be paid. Attach to the petition a list of all your non-exempt assets that can be used to partially satisfy these debts. You don't have to list any debt that you plan to pay outside of bankruptcy. But once you've filed your petition with the court, it's too late to *add* another debt to your list. Once you've filed, you're prohibited from filing for bankruptcy again for the next seven years. So any debts not discharged in the first bankruptcy action remain continuing obligations.

The next step is to file the petition with the court. From the date of that filing, you're officially bankrupt. Some people believe that bankruptcy begins from the date of your first court appearance. That isn't so. From the moment you file the petition, all suits against you, as well as collections and foreclosures, are suspended. Creditors have to wait until the court sorts things out in its own good time.



Once the petition is filed, the court will send out a notice of hearing to all creditors on your list. When the hearing date arrives, the court selects a trustee to handle the bankruptcy proceeding. This is known as the *first meeting of creditors*. In a Chapter 7 bankruptcy, the trustee eventually liquidates your non-exempt assets, as permitted under the law, and then distributes the proceeds according to established priorities. This list sets down the order in which debts have to be discharged. The tax collector gets his money first, as you might expect. Federal, state, county, and city governments, landlords, and employees come next. Once all these parties have been satisfied, your other creditors pick the bones of what's left.

Right up there with the IRS on the priority list are the court trustee, the court and the attorneys. So you can see why creditors such as your material suppliers and the phone company don't do very well in bankruptcy court, and are often very reluctant to force you into bankruptcy, especially if they think you're likely to be successful in convincing the court that you're eligible for a Chapter 7 filing.

In a Chapter 7 filing, the first meeting will probably be your last bankruptcy session. The rest is handled by the trustee of the court. Expect a Chapter 7 bankruptcy proceeding to last from six to nine months.

Voluntary or Involuntary Bankruptcy

With all this discussion of considering bankruptcy, you might think that you generally have a choice of whether or not to file for bankruptcy. Usually the indebted individual or business files for bankruptcy voluntarily, though you might feel it's a strange use of the word "voluntary" when you seem to have no other alternative. However, if your creditors feel they've exhausted all the options available to them to collect their debts, they may decide to force you into involuntary bankruptcy. In this case, your creditors initiate the bankruptcy proceeding by filing a petition to a bankruptcy court so they can eventually collect the funds they're owed.

Usually one or a number of your creditors (most likely a lending institution) will try to force you into involuntary bankruptcy if you owe them a sizeable amount of money, or if you've missed a considerable number of regular payments on a prearranged payment plan.

An involuntary bankruptcy procedure will usually take the following pattern:

- The creditor files a petition and a summons with a U.S. bankruptcy court clerk.
- The debtor has 20 days to file an objection.
- If the debtor does file an objection, the case goes to court.
- If the debtor does not file an objection, the bankruptcy proceeds.

If your creditors are trying to force you into an involuntary bankruptcy, it's safe to assume that you've already decided not to file for voluntary bankruptcy. So clearly, you should file an objection within the allowed 20 days. Then the case goes to court and there's always the possibility that the court will deny the creditor's petition. If the court does find that the case should proceed, you've now bought yourself some time, as the wheels of the law typically turn slowly. You might even have sufficient time to sort out your financial problems and settle out of court before the case is decided.

"Often, before an individual or a business files for voluntary bankruptcy, they'll unload or hide whatever assets they can..."

Many of your creditors, particularly subs and suppliers, will only try to force you into involuntary Chapter 7 bankruptcy if they feel that you're presently in the process of hiding all your assets prior to filing for voluntary bankruptcy. This is because, as we've already seen, unsecured creditors, such as subcontractors and materials suppliers, generally do poorly in a Chapter 7 bankruptcy settlement. Often, before an individual or a business files for voluntary bankruptcy, they'll unload or hide whatever assets they can, so creditors may decide they have to act quickly to stop this from happening. If you've been open and upfront with your creditors and assured them that you intend to pay them all in full, if not on time, you may be able to forestall them from filing for an involuntary bankruptcy.

Life after Bankruptcy

Once you've filed the initial bankruptcy petition, you can buy and sell new real estate, but not assets involved in the bankruptcy. But, not surprisingly, you'll find it very difficult to borrow money. However, eventually you'll build trust with lending institutions so that you can get your life back together again.

Loans are usually only offered to previously bankrupt individuals or businesses after their cases have been finally dismissed and their creditors have been paid. In the case of a Chapter 7 bankruptcy, the debtor must wait two years after his bankruptcy was filed before he can apply for a new loan. In the case of a Chapter 13 bankruptcy, creditors must be paid in full before the debtor can apply for a large loan.

The easiest way to become approved for a loan after bankruptcy is to prove to your potential lender that you're no longer a high-risk borrower. The most effective way to do this is to reestablish your credit, by paying all your bills on time, and properly managing a credit card account. Once you've done this for a while, you can request reference letters from your credit and utility companies to prove to other lenders that you're financially responsible again.

There is also the loss of self-respect and reputation to consider. By business standards, you've failed. You aren't up to par. You've been tested and found wanting. Your ex-creditors trusted you and they've had to suffer because of that trust.

All of that may be true. But it doesn't help you become a productive and responsible member of the construction community again. After all, we're all *contractors-in-training*. Sometimes we make mistakes. That's almost inevitable. It isn't the mistakes we make, but what we learn from those mistakes, that's important. Some of today's most successful contractors have gone through bankruptcy. They learned from their mistakes and used the experience to improve the way they do business. You can do the same.

Look at it this way. If you do have to file, you're going to be in good company. Major airlines have filed for bankruptcy in the last few years, and many of them are still in business. And remember K-Mart, which filed for Chapter 11 bankruptcy in February 2002 when their stock fell to junk status, then re-emerged 15 months later and saw their stock rise to over $100 a share. The Chrysler Corporation is another good example, and there are many, many more.

Another problem to cope with is your credit rating. Bankruptcy is going to follow you around for several years to come. You have to reestablish good credit. It's like being a teenager again without any credit cards and charge accounts. But it won't be so hard to get them set up this time because you've been through it all before. At least now you understand how to do it.

"Some of today's most successful contractors have gone through bankruptcy."

But don't expect the fact of your bankruptcy to disappear as time passes. Every time you apply for credit, you have to reveal the bankruptcy. The record is passed on from creditor to creditor. And there's nothing you can do to erase your bankruptcy from the records of the credit-reporting agencies for several years. The best you can do is to stay current on all your obligations in the future.

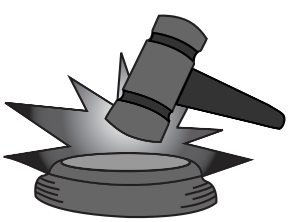
On the other hand, after having pondered filing for bankruptcy for a while and taken the best legal advice you can afford, you may feel that you'd prefer to fight it out. So let's spend some time looking at the possible alternatives to filing for involuntary bankruptcy. Clearly, for any of these to be useful, you'll have to prevent your creditors from filing to force you into involuntary bankruptcy. As we've just said, this will generally require you to be honest and convincing with any repayment plan that you propose to pay off their debts. So have a very well thought-out and presentable payment plan available if you plan to fight it out.

Alternatives to Filing for Bankruptcy

You may decide you can just about ride out your financial problems, convince your creditors you have a viable plan to pay them off, and persuade them not to force you into involuntary bankruptcy. If so, you'll still face the possibility of lawsuits being filed against you, particularly if you occasionally fall behind in payments on your plan.

Lawsuits and Judgments

Legal entanglements are frustrating, awkward, time-consuming and expensive. Stay away from lawyers if at all possible. But sometimes there's no practical alternative to filing or defending a lawsuit. A contractor fighting for financial survival has a major disadvantage in court. His financial condition is completely irrelevant. The court hasn't the slightest interest in the condition of the economy or the condition of your finances. That's your problem, not the court's.



The fact that a lawsuit might tip you over the brink financially is also irrelevant. In a debt lawsuit, the court is only concerned with the debt itself and the facts that created the debt. Do you owe the money or don't you?

But courts also take a narrow view on some other issues. And this time, they're to your advantage. *There's a principle in the law that no one can sue for losses that haven't yet actually occurred.* Here's an example — suppose you have a contract with a homeowner to do some remodeling work and you contract out some of the work to a subcontractor. You get paid by the owner for the work that the subcontractor has done, but because of other bills you had to pay, you don't have enough money to pay the subcontractor. The sub decides to sue the owner to collect for the work he's done and gets a judgment for the full amount. The owner refuses to pay on that judgment and he sues you because he's already paid you. However, the judgment itself isn't a payment. It's only an obligation and the law says there are no grounds for the owner's suit yet. The owner has to pay the sub (as well as the payment he's already made to you) before he's deemed to have suffered a loss. Only then can he sue you to recover for the double payment.

This doesn't mean that the owner can't turn you in to the Contractors Licensing Board. It only means that a legal right to sue doesn't exist until an obligation has been paid and a loss has actually occurred. That's not to say, of course, that the subcontractor can't sue you for payment, but he'll probably realize that you're now in financial stress so, even if he gets a judgment against you, you may have nothing to settle the judgment with. One alternative is for him to force you into involuntary bankruptcy, but that's not something that a small subcontractor is probably going to do, as his legal fees are likely to be more than his outstanding bill. Remember, subcontractors generally do very poorly in bankruptcy settlements. But there's still small claims court to contend with, which we'll come to in a moment.

The Legal Process

Here's a chronological rundown of a lawsuit. Actual practice varies in some states but generally the procedure will be as follows. The major exception is small claims court. In small claims court, the procedure is simplified in many respects. The first step is service of process. You'll be handed a package of papers that have been prepared by the attorney for the plaintiff (the person who has the complaint against you). Among these papers will be a summons and a complaint. The summons tells you how much time you have to file an answer to the complaint and where that answer has to be filed. The complaint explains in legal language exactly what the plaintiff is complaining about, and what he wants the court to do to solve his problem.

Make a copy of every page of the summons and the complaint for your attorney. *Write on the summons the date when you were served.* At this point you have three options. First, you can try to reach a settlement with the plaintiff within 30 days of service. Second, you can file an answer to the complaint to indicate that you plan to contest what the plaintiff claims. Third, you can do nothing. Making no response gives the plaintiff the right to take a default judgment. That's the legal equivalent of you admitting that you have no defense to the complaint. (If you accept the default, expect to have the sheriff visit you to pick up some of your assets within about 60 days.)

If you file an answer to the suit, you set in motion a chain of events that must occur before there's any obligation to pay the amount requested. You'll probably want to have an attorney prepare an answer for you. If so, forward a copy of the summons and the complaint to the attorney right away. *Remember, there's a 30-day time limit on filing your answer.*

It's perfectly acceptable to send copies to several attorneys. Ask each of them to suggest the correct action you should take, and ask them to quote a fee for doing the work required. Then you can select the attorney that seems to have the best plan and the most reasonable fees.

To confuse matters, consider filing a countersuit against the plaintiff. This makes your plaintiff file an answer in response and puts some risk into the suit from his standpoint, as well as increasing his attorney costs. This is called a *cross complaint*. It makes resolving the suit more difficult and time-consuming. It also increases your legal fees, but it's good leverage.

Once your creditor has sued, you've answered, you've countersued, and he's answered, it's time to prepare for trial. This process is called *discovery.* It usually involves *depositions* (giving testimony under oath at the office of one of the attorneys) and *interrogatories* (written questions exchanged by the parties). When this process is completed, the plaintiff will file an *At Issue Memorandum* to indicate to the clerk of the court that the parties are ready for trial — that is, they've finally come to the issue.

The clerk assigns the first available court date to try the case. Usually that will be months away. Figure 3-1 gives an indication of the typical amount of time consumed by various court procedures.

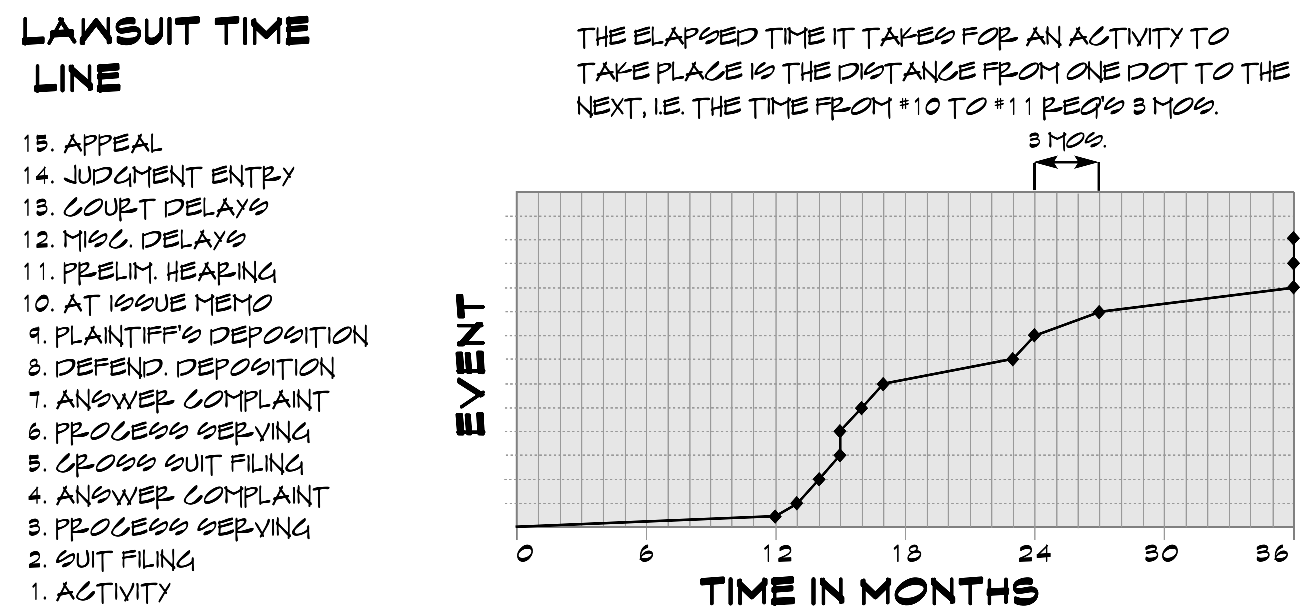
When your court date rolls around, you may decide to go through with the trial or attempt to settle without trial. The court encourages, if not actually requires, a pre-trial settlement meeting, and may pressure the parties to settle without trying the case. At least 95 percent of all cases filed are settled without a trial.

If the trial goes ahead and you end up losing, the plaintiff gets a judgment against you. That's like a hunting license. He still has to find some of your assets and get the sheriff to seize them on his behalf. If he can't find any assets, he can require you to attend a debtor's examination and answer questions under oath on what you own and where it's located. Most states have a limit on how often these examinations can be scheduled. Usually it's every six months. In between examinations, they have to leave you alone.

The sheriff does the actual work of seizing assets. He can levy execution against bank accounts or personal property such as a car, furnishings and equipment. Or he can garnish wages in the hands of an employer, if that's the case (though probably not, if you're an independent contractor). But this process is expensive for the plaintiff. He has to post a bond of several hundred dollars before the sheriff will do anything. Some of these costs can be recovered from the judgment debtor when the assets are sold. Generally, the larger the asset to be seized, the more expensive it is for your creditor to seize it. But that doesn't mean he won't try.

Sheriff's Keeper

The law in many states permits the installation of a *sheriff's keeper* at the debtor's place of business. A keeper is a uniformed sheriff's deputy. He goes to the debtor's place of business and can take any of several actions, depending on the creditor's instructions. The keeper can make a *till tap*,



Lawsuit time line
Figure 3-1

(i.e. pick up any cash or negotiable instruments belonging to the business). He can also take possession of the premises for the day, seizing any cash that comes in. Finally, the keeper can take possession of the entire premises for 24 hours. At the end of that time, the keeper calls for bids from moving companies to move all the debtor's furnishings and equipment into storage. The creditor has to post a bond to cover the costs of moving and storage, which may be several thousand dollars for an ongoing business.

The keeper can be authorized to accept a certain amount of cash from the debtor to satisfy the debt. And that's usually what happens. Nothing disrupts a business faster than having the sheriff's keeper unroll his sleeping bag at the reception desk and announce that he's taking possession of the premises. That brings a debtor to his knees in a hurry.

Keepers are expensive, though. In a larger business, one keeper is needed for each exit. The fees for a sheriff's keeper are typically $300-$350 for each 8-12 hour day. But generally, it takes only one day to collect the debt.

The End Game

It isn't cheap to find and seize assets. If the debtor has none available, or if the creditor doesn't have a deep pocket, it may be wiser for him to just record an *abstract of judgment* with the clerk in his county. If the judgment debtor ever tries to sell land in that county, the abstract will show up in the title search as a lien on the property. The buyer will then insist that the lien be paid off before he takes title.

If you have few assets and little income, your creditor's efforts may be futile. He can't get what you don't have. If you lease your vehicles and homestead your house, you leave little that is accessible to a creditor. Converting vulnerable assets into cash, a commodity, or selling them to a friend may discourage your creditor to the point that he gives up the chase.

But even if the creditor gives up for the time being, the judgment is still valid and it's earning interest at the rate established by the law. Once you're back on your feet and making money once more, the creditor can come after you again for up to 10 years, and for up to 20 years if he renews the judgment at the end of the first 10 years.

Let's say that you elect to settle rather than go to trial. You and your attorney agree on a settlement amount with the plaintiff and his attorney. The plaintiff will probably want the settlement written up as a consent to judgment with a strict payment schedule. A consent to judgment is more effective than a simple promise to pay. To enforce the latter, the plaintiff would have to sue all over again. A judgment, on the other hand, can be entered directly and enforced by levy without a trial.

As long as you meet the requirements of the payment schedule, the judgment never becomes a public record. However, if you default on your payments, your creditor's attorney will request that the judgment be entered. But it's still up to the creditor to collect. And he has to locate your assets, just as before.

Compromising Debts

Compromise is usually the best way to settle any dispute. That's the reason why compromising debts is a good way to handle bills that can't be paid on time. If you can't pay the whole bill, then why not offer to pay half and call it settled? Believe me, it's done all the time. After all, that's exactly what happens in a Chapter 7 bankruptcy. The court-appointed receiver liquidates your assets and distributes the proceeds as far as they'll go to all the creditors. Most general creditors will get only a few cents on the dollar.

Offer to compromise with your most demanding creditors. Be as persuasive as possible. And if you do reach an agreement, *be sure you have it put in writing that any payment you make is done so in full satisfaction of the total amount owed.* You don't want your creditor to claim later that the money received was only on account, with the remainder to be paid later. One way to do this is to note on your check that endorsement by the depositor acknowledges compromise of the debt, and that the amount paid is accepted as payment in full on a particular job or invoice.

"Offer to compromise with your most demanding creditors."

Occasionally, there'll be a real estate developer who'll make a habit of deliberately paying fifty cents on the dollar. He'll contract with a builder to do a job and then delay payment because of some real or imaginary discrepancy. When the contractor is buried financially and strapped for cash, he'll offer to pay fifty cents for each dollar owed. The offer usually comes with a challenge — "Sue me, and I'll go bankrupt on you." If this happens to you, you may feel you have very little choice but to accept. You're out of money, and can't really afford the legal fees needed to sue the developer. You may feel that compromise is the only way to keep your business operating. It's a matter of survival. Fortunately, these characters don't come out of the woodwork very often, but be very careful to avoid them by checking out the on-time payment history of any developer you plan to do business with. Contact other subcontractors on his jobs.

There's a basic difference between compromising your debts because they can't be paid in full and planning from the beginning to pay less than the contract amount. Here's what to do if you belatedly discover that you have contracted to do some work for a fifty-cents-on-the-dollar operator. First, decide that you've made a mistake in working with this guy and resolve never to do it again. Next, decide to do without the money for the time being. Then, if you've cultivated your attorney, kept him in the loop, and if he's very understanding when it comes to getting paid on time, go after this guy in every way possible. That includes putting liens on his clients and his projects, attaching his wages, and phoning him every day, twice a day, even on weekends and holidays. This repetitive phoning is a very effective tool. You can often get a shady developer to pay you just to get you off the phone! Perseverance is what counts, so make sure that you have more than he does.

Asset Protection and Trusts

Let's say you're considering voluntary bankruptcy, or you suspect that your creditors may be planning to force you into involuntary bankruptcy. Or maybe you're involved in a big lawsuit that you're not sure you can win. Either way, you stand to lose whatever assets you've built up over the years.

> "One way to protect your assets is to put them into a trust."

In such cases you should plan to protect your assets, and there are some basic points to understand about the subject. First, if you've recently transferred assets to friends, relatives, or business associates, the court can view this as a deliberate attempt to defraud your creditors. The court has the power to freeze assets in the hands of your friends, associates, or relatives, and can issue a deed to property, if necessary. This could prove very embarrassing to your friends and expensive to you. But there are acceptable ways to transfer assets.

If you're going to transfer assets to protect them from creditors, do it long before your case is filed and comes to trial. Make each transfer, as much as possible, an ordinary business transaction. Just hiding assets won't deceive anyone. And, of course, keeping the proceeds of any such liquidation in a bank account is just inviting court action. It can also create serious tax problems for you.

One way to protect your assets is to put them into a trust. There are several types of trusts — the testamentary trust, the revocable living trust, the irrevocable trust, the pot trust and more recently the rather blatantly termed asset protection trust, which we'll address in a moment. There are many variations on trusts, but only the irrevocable trust and the asset protection trust, not surprisingly, can effectively protect your assets. The other trusts are accessible to both you and to your creditors in one way or another. You can get specific information from the trust department of your local bank or from an attorney who handles estates and trusts. You can also find some useful information, as usual, on the internet, at www.nolo.com. As a rule of thumb, if you can get into your trust, so can your creditors.

Trusts have been used for many years to preserve assets for future generations. *The problem with most trusts is that they don't fully protect your assets until after your death.* One way around this problem is to put your assets into an *Irrevocable Trust*, with someone else as trustee and beneficiary of the trust. The court regards this trustee as an uninvolved third party. The difficulty with this arrangement is that you lose control over what happens to your assets — that's what irrevocable means, *you can't revoke it* — and obviously, you can't sell the assets. Also it's next to impossible to borrow against the assets held by a trustee in an irrevocable trust. An irrevocable trust does protect your assets during your lifetime, but as we've just learned, you can't revoke the trust or have access to the assets in it unless the trustee voluntarily returns the assets to you using another irrevocable trust with you as the trustee.

Before considering an irrevocable trust, you need to have a very strong relationship with the trustee, who you'd be confident would eventually, when the coast was clear, return the assets to you with another irrevocable trust. This is clearly risky, as relationships, however solid they may appear at the time, can change unexpectedly. And it's an obvious way of hiding assets improperly. So you must let considerable time pass before you ask the trustee to return the assets to you, all the while increasing running the risk of your relationship with your trustee going sour. It's a delicate balancing act. Be sure to get competent legal advice before considering such a strategy.

For a number of years, it's been possible to set up *asset protection trusts* overseas. However, they've been complex and expensive to set up, and therefore typically only used by the super rich. More recently, Alaska broke with tradition and allowed asset protection trusts to be set up there. Again, they are expensive to set up, costing many thousands of dollars, and expensive to maintain, as you need to pay an in-state trustee, costing you many more thousands of dollars. These asset protection trusts became a very nice money earner for the State of Alaska, since they're used by the rich and especially by doctors who want to protect their assets from malpractice judgments. Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota and Utah have also decided to allow asset protection trusts to be set up in their states. However, these trusts still cost many thousands of dollars to set up and maintain, and are typically only used by the wealthy, ruling out their use by those of more modest means, like most small building contractors.

Corporations and Asset Protection

The corporate form of organization can help you protect your assets. In fact, the corporation was originally developed to provide limited liability for investors. Each investor is liable only up to the amount of his investment in the corporation. Any more than that amount of each investor's assets the corporation's creditors can't reach.

The corporate form offers some protection from lawsuits. A big judgment against the corporation may send it into bankruptcy. But you can walk away free of obligation even if you were the 100 percent owner. It's the corporation that's responsible, not you personally.

"No one will accept the corporation's credit until the corporation has established considerable assets."

There's still danger here, however. Nothing in the law is that simple. First, a corporation is only valid if it's formed properly, operates as a separate legal entity, and has adequate capital, so you have to deposit a certain amount of your assets in the corporation in order to form it. The problem is that no one can really define what constitutes an adequate amount of capital. In court, the plaintiffs may pierce the corporate veil by showing that the corporation was only on paper and had no real existence of its own. If they manage to do that, they've eliminated all protection the corporate form might offer you.

Another difficulty is that most suppliers will want you to sign personally for all major purchases and loans. No one will accept the corporation's credit until the corporation has established considerable assets. Also, note that *anyone suing the corporation can also name you personally as a second defendant.* That's a perfectly acceptable legal practice.

This leaves you with the problem of showing, in court, that it's the corporation that's responsible for the debt and not you. You have to prove it, and pay for the proof. It's far from automatic.

Finally, the corporation has to pay income taxes, just as individuals do. You can take a salary from the corporation, which is deductible as far as the corporation's taxable income is concerned. However, if you choose also to pay dividends to the shareholder(s) (i.e. yourself, and perhaps a small number of other shareholders who own part of the company), those dividends are not tax-deductible for the corporation, but are considered taxable income on your (and any shareholders) personal taxes. While there are moves in Congress to do away with this double taxation whammy, it presently means that any dividends the corporation pays you are doubly taxed.

The alternative is to pay yourself a fat salary and not declare a dividend, but this practice will very likely fall foul of the IRS if your salary is outside the reasonable range, and if the corporation accumulates or retains earnings beyond the needs of running the corporation without paying a dividend. If the corporation is profitable and it doesn't pay any dividends for an extended period of time, the IRS is likely to conclude that some of the salaries being paid to the owners are really disguised dividends. The IRS can then disallow some or all of the salaries as tax deductions for the corporation, resulting in a large tax bill plus interest and penalties. If you've formed a corporation, your best bet is to ensure that all salaries paid are not significantly higher than the accepted standards for a small contracting business, and to pay out at least some dividends each year.

Another consideration before forming a corporation is that for taxable earnings up to roughly $60,000, tax rates for corporations are lower than those for married couples filing jointly. Above that, the corporate tax rates are either the same or somewhat higher. Also, you'll need to hold at least one annual stockholders' meeting and keep corporate minutes. This all takes time and money, and is worth considering in deciding whether or not you should go to the trouble of forming a corporation. You'll probably need professional help to make this decision.

You may decide that running your business as a corporation is just too much of a nuisance. Unless you're running a substantially-sized operation, forming a corporation may be more trouble than it's worth — at least in the context of protecting some of your assets.

If you do incorporate, it's critical to separate your personal assets from the assets of the corporation. Don't mix corporate and personal funds. Have an invoice or payroll record on file for every check the corporation writes. Don't use corporate assets for personal purposes. Make sure every dollar you take out of the corporation is recorded as salary, reimbursement of expenses, or dividend. Any transaction between a closely-held corporation and its shareholder-owners is likely to attract very close examination by IRS agents. If corporate property is diverted to the shareholders, they'll be considered to have received a *constructive* or *preferential* dividend. The tax treatment for such a transaction is highly unfavorable because this dividend will be taxable to the owners, but not deductible to the corporation.

"Unless you're running a substantially-sized operation, forming a corporation may be more trouble than it's worth ..."

One last note before we leave the subject of corporations. If you're having trouble making loan payments on a piece of land, and you're on the verge of losing it, consider forming a corporation and transferring the property to the corporation. After a while, put the corporation in Chapter 13 bankruptcy.

The bankruptcy court will put the corporation's creditors on ice for a number of months while you're making payments under an extended payment plan.

Under Chapter 13 the court offers protection for at least three years while you pay off creditors. Creditors have to conform to the corporation's ability to pay. Depending upon the term of the original loan, this may reduce your loan payments substantially and give you many months to pay off the loan. It could be enough time to avoid losing the land's equity. With any luck, you'll be able to sell it at a profit long before the three years have passed.

Homesteads as Asset Protection

In some states, builder/contractors may use the homestead law to protect their primary residence from attack by creditors, although the amount of protection provided varies greatly from state to state and will change over time. For instance, the homestead limit in California was originally set at $7,500 but has been revised upward numerous times to reflect the increase in value of property, and now sits at $50,000. Today, in California, the homestead exemption protects the first $50,000 in equity in your home, so if a judgment against you is for less than $50,000, the creditor cannot collect on the equity in your home. However, if the judgment is for greater than that amount, the balance of the equity in your home is vulnerable.

You should note, however, that while California has a reasonable homestead exemption figure, the homestead exemption varies. So be sure to check the figure for your own state before expecting that your state's homestead law will give you any significant amount of home equity protection. For instance, in New Jersey, Pennsylvania and District of Columbia there's no protection under a homestead exemption. In Alabama the exemption is set at only $5,000, while Nevada's figure is set at $350,000 and Rhode Island's is set at $200,000.

In some states, such as Florida, Kansas, Iowa and Texas, there's no monetary limit, although the 2005 bankruptcy law put a new wrinkle in that. If the property was purchased less than three years before the bankruptcy filing, the homestead limit in these four states is now set at $125,000. So the quick purchase of a mansion in one of these states, just before filing for bankruptcy, will now protect only the first $125,000 in equity — even so, that's not chicken feed. Also note that in Texas, a homestead exemption provides no protection from debts owed to the federal government. The downside of an unlimited homestead protection, in Texas, for example, is that home equity loans are not available there since the lender has no security from the equity in your home.

It's easy to declare a homestead. Your local stationery store probably has a standard Declaration of Homestead form for your state. If not, you can always get one from the tax assessor's office in your county, the address of which you'll find on your property tax bill. Fill in the appropriate blanks for address, assessor's parcel number, legal description, name, and so on. This information will be on your tax bill. Have your signature notarized and then take the document to the county recorder's office for recording. Congratulations! If you live in California, you've just protected the first $50,000 of equity in your home. That's all there is to it.

REFINANCED EQUITY PROTECTION (CALIFORNIA)

ORIGINAL CONDITION	HOME VALUE	$350,000
	FIRST TRUST DEED (MORTGAGE)	$146,000
	EQUITY IN THE HOME	**$204,000**
	HOMESTEAD PROTECTION (CALIFORNIA)	$50,000
	UNPROTECTED EQUITY	**$154,000**
REFINANCED CONDITION	HOME VALUE	$350,000
	80% FIRST TRUST DEED (MORTGAGE)	$280,000
	EQUITY IN THE HOME	**$70,000**
	HOMESTEAD PROTECTION (CALIFORNIA)	$50,000
	UNPROTECTED EQUITY	**$20,000**
	NEW SECOND TRUST DEED (MORTGAGE)	$20,000
	REMAINING EQUITY	**$0**

Refinanced equity protection (California)
Figure 3-2

Today, homestead exemptions are generally covered by the *Automatic Acknowledgement Statute*. This means that you don't actually need to record your homestead document. The court recognizes your homestead rights automatically, without any effort on your part. But to be on the safe side, I'd fill out the homestead form and record it. The security of your home is too valuable to take lightly. Do all you can to protect it.

If the equity you have in your home is greater than the homestead limit, (e.g. $50,000 in California), the balance is subject to claim by your creditors. But there's another maneuver to protect that.

Borrowing All the Equity of Your Property

One method of protecting the balance of the equity in your property is to encumber it somehow. You can simply borrow all the equity out of the house. If you can get a high appraisal, pull the full equity out, except for the protected $50,000 in California (or the appropriate amount in another state). Look at Figure 3-2. In this example, you can protect your equity by refinancing the first trust deed and taking out a second for the balance of the equity.

The only problem with this maneuver is that you have to pay the loan fees up front, make monthly payments on the larger, refinanced loan, and you have to hide the equity you've taken out of the house to keep it away from your creditors.

A somewhat easier solution is to keep your present mortgage and get a friend or relative to record a large second mortgage. This doesn't have to involve any actual cash transaction. Just record the mortgage on the property,

ADDITIONAL 3RD TRUST DEED EQUITY PROTECTION (CALIFORNIA)

ORIGINAL CONDITION	HOME VALUE	$350,000
	FIRST TRUST DEED (MORTGAGE)	$146,000
	EQUITY IN THE HOME	**$204,000**
	HOMESTEAD PROTECTION (CALIFORNIA)	$50,000
	UNPROTECTED EQUITY	**$154,000**
NEW CONDITION	HOME VALUE	$350,000
	FIRST TRUST DEED (MORTGAGE)	$146,000
	EQUITY IN THE HOME	**$204,000**
	HOMESTEAD PROTECTION (CALIFORNIA)	$50,000
	UNPROTECTED EQUITY	**$154,000**
	NEW SECOND TRUST DEED (MORTGAGE)	$80,000
	NEW THIRD TRUST DEED (MORTGAGE)	$74,000
	REMAINING EQUITY	**$0**

Additional 3rd trust deed equity protection (California)
Figure 3-3

showing that all of your equity, except the homesteaded $50,000 (California, remember) has been exhausted.

In Figure 3-3, we begin with the same original situation as in Figure 3-2. But instead of refinancing the first trust deed, you can create a new second trust deed in the amount of $80,000. This can be a loan from a bank, a friend, or a relative. Now you have only $74,000 in unprotected equity. You can cover that with a new third trust deed. You probably can't get that from a bank, so you may have to depend on a relative. If you've already borrowed from your family, record that debt as a third trust deed. It gives them some collateral and helps protect your equity. By doing all this, you leave your first mortgage intact and unaffected, and your equity appears non-existent and can't be liquidated in bankruptcy.

Converting Your Assets to Commodities

Another alternative is to sell all your assets and convert the resulting cash into a commodity that can't be traced, doesn't require upkeep, and isn't adversely affected by economic cycles. Food, for example, is unsuitable because it deteriorates. Stocks and bonds won't do because ownership is recorded. A product in its rawest possible refined condition is a good bet. Pure copper in ingot form fits this description. It won't deteriorate, requires little care, and ownership isn't recorded. It's too heavy to carry off in a bag, and may well increase in value over time, although, of course, it may also fall in value, just like stocks.

If you do convert assets into a commodity like copper ingot, keep it out of state, out of sight, away from relatives, and under lock and key. The less you say about the commodity, the more secure it will be. As above, you should also let considerable time pass before considering the reverse transaction and converting the commodity back to cash.

Foreclosures

A financially-troubled contractor with property to lose should know everything there is to know about foreclosure proceedings. He may need it. Unfortunately, the exact details are different in every state. I'll outline the broad concepts here as they apply to California, where I do business. Get specific guidance from a lawyer familiar with foreclosures in your state.

There are two kinds of foreclosures — judicial and real estate. We'll concern ourselves only with the real estate foreclosure.

Real estate foreclosures are used for real property that has been provided as security for a deed of trust or mortgage. There's a misconception that foreclosure proceedings can't be started on a piece of property unless you're at least 90 days behind in your payments. That's not true. Here's the way it really works.

Let's say your loan payment is due on the 5th of the month and you don't make it; you're legally in default. On the 6th day of the month, your mortgage holder can serve you with a *Notice of Intent to Foreclose*. Once he's done that, the clock is ticking. You now have 90 days to make those back payments, plus any trustee's fees and recording costs, or taxes and assessments if applicable.

Normally, a mortgage holder won't send you a foreclosure notice until you're at least 90 days behind in your payments. *But it's entirely up to him.* He can be lenient or not, as he chooses. So, be nice to your mortgage holder. People don't like to foreclose on friends. If, within the 90-day redemption period, you make good on your payments, that's the end of the story. If, on the other hand, you don't pay up, the property is ordered to be sold at auction. The date of the sheriff's auction is typically 30 days after the order is issued by the court. Up until the actual time of the sale, or a couple of days before, you can still redeem your property by bringing your payments up to date and paying the related expenses. For that you'll need a new loan, which, at best, will be especially difficult to find when you're going through foreclosure. There's danger to the bank in saving a drowning man. The victim may drag the bank down too.

Mechanic's, Contractor's or Construction Liens

These three alternative names for the same instrument are generally lumped together under the term *mechanic's liens*. Mechanic's liens are intended to level the playing field between an owner who has contracted to have work done and the individual who has performed the work, but for whatever reason hasn't been paid. In these circumstances, most of the power is in the hands of the owner. He has both the money and the completed work. There's little that the contractor can do to persuade the owner to pay. There's not much purpose in undoing the work he's done, which takes time and effort, and throws good money after bad.

So states instituted the lien process, which in principle is a good idea, but in practice can cause all sorts of problems. For instance, just as we saw in Lawsuits and Judgments, an owner may give you a contract for some remodeling work, and you get a sub to do part of the work. All the work gets completed and the owner pays you the full amount. You don't pay the sub, because you have more pressing bills to pay. In this case, the law gives the sub the right to place a lien against the owner's property. The best protection for the homeowner is to hire a contractor who is financially sound and has a good record of paying his subcontractors, but that's not always easy to establish.

So what effect does this have on you? A homeowner who's looking for a contractor to do some remodeling, and is checking out a few potential contractors, may ask you this question: "Have you ever *not* paid your subcontractors, resulting in a lien being placed against the owner's property?" Also, he might ask you for a list of the subcontractors, materials suppliers, architects, etc. (all of whom are entitled to place liens on his property if they're not paid by you), that you intend to use on the project. He may also ask you for notarized letters from each of them confirming that you've always paid them on time. This is clearly going to cause you a problem if you're in financial distress and having difficulty paying your bills.

A lien is simply a matter of public record which states that there may be a valid, unpaid debt against the specific property named in the lien. In some states, a lien can be a very powerful legal instrument. The way it works varies considerably from state to state, but, the principles are the same. Anyone who has furnished labor or materials to build or repair something should be able to use the value in the item built or repaired as security if he doesn't get paid.

A lien is a security interest, like a mortgage. But unlike a mortgage, mechanic's liens don't have a power of sale. The lien holder can't sell the property. He has to be satisfied with holding the lien until the owner wants to clear his rights to the property, typically when he wants to sell it.

The lien holder has a right — the right to get paid by the owner before title to the property is clear. Typically, the lien holder gets paid when the property is sold or when the owner wants to take out a new loan on the property. There is no alternative; the owner can't give clear title to the property, and any new lender would be subordinate to the lien holder.

"Here's the biggest problem with mechanic's liens - the system only works if everyone lies..."

Some states (e.g. California) have special requirements that must be followed before lien rights can be enforced at all. For example, anyone without a direct contract with the owner, (i.e. one of your subcontractors), may have to present a *Preliminary Notice of Intent to Lien* to the owner, the general contractor, and the lender. If the subcontractor doesn't do this within 20 days of starting work, he may lose all lien rights. However, he's only going to do this if he suspects that you may be in or approaching financial distress. In practice, he probably wouldn't accept a job from you in the first place if this was the case and there were any other jobs he could work on.

However, when times are bad and there isn't much work to be done, a subcontractor may take the risk, and protect himself by submitting the necessary paperwork, as above. But remember, a lien isn't the same as getting paid for the work done, by a long shot. It will only protect the subcontractor inasmuch as he'll eventually get paid when the property is sold or the owner wants to take out a loan using the property as security — not really a very good deal for the subcontractor!

Here's the biggest problem with mechanic's liens — the system only works through deception. The subs don't get paid until they give the general contractor a labor and material lien release. But the subs can't get releases from suppliers and tradesmen until they're paid. And if the sub hasn't been paid, how can he pay anyone else? He can't. So each sub must trust you, and sign a release before actually *getting* paid. Each subcontractor has to lie to the general contractor by saying that he's already paid all his labor and material bills.

That's the dilemma for every contractor who's running a business on limited capital. There's no easy way around this problem. If you, the general contractor, get paid, but you don't pay your subcontractors and material suppliers, they can lien the owner's property. Or they can sue the owner for payment a second time if they're not prepared to wait, as we saw in Lawsuits and Judgments. If they've filed the Preliminary Notice within the required 20 days, they'll probably win and the owner will have to pay a second time. Then he'll sue you to get back the money that he paid you when the contract was completed. What a mess!

The best way to avoid potential problems with mechanic's liens is to have enough money to pay all your labor and materials bills before getting paid by the owner for the work done. But not many small contractors are in a position to do that, certainly not if they're in financial difficulties. However, knowing about the possibility of liens prepares you to avoid the situation, if at all possible. Remember, an ounce of prevention is always better than a pound of cure!

Summary

Bankruptcy is never an easy decision. Use it only if you've no other alternative. Bankruptcy can offer you protection from creditors and the prospect that debt payments will be spread out over an extended period of time, or adjusted or even forgiven completely. But there are substantial penalties — loss of self-esteem and a bad credit history. *You now have a reputation.*

The threat of declaring bankruptcy is a powerful weapon to keep some creditors from suing you. A creditor probably doesn't know exactly what financial shape you're in and, particularly if he's a small unsecured creditor and sues you, he may end up with nothing out of a bankruptcy procedure. On the other hand, if he hangs on, he might eventually get paid at least some of the money he's owed. Lawsuits against you can also work in your favor if time is what you need. To buy even more time, file a cross-complaint. If the court decides against you, remember that seizing assets is expensive for the creditor. Many creditors will only record the judgment, hoping to get paid eventually. *That buys you time.*

If you intend to liquidate your assets, do so long before any trial. Consider compromising on your debts with receptive creditors and converting cash into a commodity that can be stored out of sight. Trusts, corporations, and homesteading are other alternatives for protecting assets. Make sure you know all about foreclosure in your state and be aware of mechanic's liens.

The purpose of this chapter has been to give you a brief overview of bankruptcy laws as they apply to individuals and small building contractors, what the alternatives are, and how to handle bankruptcy if there's just no other alternative. This advice is intended to help you get back into financial health and to pay off your creditors, not to cheat them out of their rightful earnings. They've worked hard for their money just like you have, but there are times when you need more time than originally agreed to in order to make these payments.

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One Problem at a Time

After all the heavy stuff in Chapter 3, it's time for a reality check. Take things one step at a time. Yes, it may be a crisis but it's not panic time. What you need to do is carefully examine the state of your finances, including:

- A Financial Statement — a detailed assessment of your current assets and potential income
- An Income Inventory list, and
- An Indebtedness Priority list — an evaluation of which debts must be paid and which can be delayed if necessary.

Then you can start to make some decisions. But don't try to make all these decisions on your own. Bring your spouse or partner into the picture. They have a stake in the outcome as well. These are decisions you're going to have to live with for a long time, so *take* your time.

Your Home, Your Home Phone and Your Privacy

While you're working yourself out of a financial hole, it's important to protect your family from the trauma as much as possible. They deserve a quiet, peaceful, environment in which to live. Running a business, particularly one that's struggling, out of your living room will be bad for both business and for your family. Even though you may not intend for it to happen, your family members will get involved in the business just by answering the telephone. Let's face it. An angry client needs more personal treatment than your five-year-old son can provide.

When your plumber's upset because he hasn't been paid, who explains to him that you're not in and won't be back for several hours? When one of your checks bounces, should it be your spouse who has to explain why? Your family also becomes the first point of contact with prospective clients, and that may not give the best impression. These are the problems that come with trying to run a business out of your home.

"Separate your business life from your home life as much as possible."

Business is business. Your family life is too precious and delicate to let it be upset by problems associated with your construction business. Your home is your entire family's castle, not just yours. Your children, bless their hearts, don't care what you do for a living. And why should they care? Children have other problems to deal with — like who ate the last of the peanut butter, and how to get out of doing the dishes. You may take your kids out on the job site to clean up and do minor work, but their involvement should be infrequent and semi-voluntary.

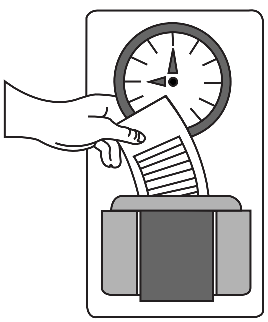
My best advice? Separate your business life from your home life as much as possible. Move your office, phone, fax and computer out of your home, even if it's only into the garage. If you must give your home phone number to a client, make sure you have an answering machine on the line so that a family member can first find out if it's a business or a personal call before answering. If a client leaves a message, make sure that the family member calls you on your cell phone right away so you can call him back. There's nothing that impresses a client or a supplier more than an instant response, and nothing he hates more than having to wait for hours for you to get back to him, especially if you owe him money.

With cell phones, it's not easy to get away from your business, day, night or even weekends, for that matter. But in some respects you don't want to, especially when you need new business. You never know when that special customer is going to call. He might talk to his wife about their new extension on a weekend or evening and want to call you immediately. If he sees your name in the local paper in the evening, or his golf partner mentions your name during a round on the weekend, he may just decide to call you there and then. It could be the contractor who answers the phone first that gets the job. At the very least, you're off to a good start and may get a face-to-face meeting, present your estimate first, and, with any luck, lock up the business while your competitors are still getting around to answering his phone message.

Customers expect instant response these days, and if you can give it to them you'll be one step ahead of the crowd. But try to do it on your own terms. If you're out with your spouse for that special anniversary dinner, make sure you switch your cell phone to the answering service. There are some limits that you have to set for yourself. But as soon as possible, check for any messages and call back, making sure to mention why you weren't able to answer the call. Your customer will be impressed that you've got your priorities right.

Time Off

Time is your most precious asset. And time off is perhaps your most precious reward. It's tough to manage your time when your business is struggling and everyone seems to be chasing you for something at the same time. You'll have to limit your time off while sorting out your financial crisis. After all, it's business life or death. But be sure to explain to your family what you're doing, and that things will improve in the future.



Once your company is making money, the idea is to get more free time. Do this by keeping a sharp eye on the number of hours you work. 6:00 a.m. to 6:00 p.m. is plenty. You're only half as efficient after that, anyway. But make your work time count. Work hard when you work, and on jobs that pay well. But when the day is over, quit and go home. You deserve any time off you can get.

At the moment, you clearly can't afford two weeks on Maui, but you may be able to fit in a long weekend camping, fishing, hiking in the mountains or just relaxing at the lake. When money's tight and you and your spouse are tired of the kids, try hiding out at the house of some friends while they're out of town for the weekend. Two days off, a nice dinner, a bottle of wine and some soft music can make up for a lot of stressed-out work weeks and making the family play second fiddle while you work out your problems. And it does wonders for your relationship.

Employees

As you build your business, select employees and associates for their intelligence and skill, and their ability to add something to your company. It's hard to determine from a short interview whether a job applicant can think for himself and act responsibly under the pressure of an angry customer shouting at him. But that's important in many jobs. Of course, you'll have to pay them on time if you want to retain them. You need employees who can handle difficult situations with unhappy customers. You're probably not going to be on-site all the time, so it'll often be one of your employees that the customer will complain to first. Take some time to teach your employees how to handle customer complaints, how to calm the situation and pass on a message to you quickly and accurately, so that you can get on top of the problem. The last thing you need is an employee who bad-mouths you in front of a customer. So look after your employees, but be sure they're looking after your interests as well. Make a note to ask your customers how each employee is doing, professionally and personally — both are important to maintaining a good business environment.

Some subtle and some not-so-subtle points deserve consideration when looking for new employees. Are they married, and if so, for how long? Have they been divorced? Do they rent or own their home? How long have they lived in the area? Do they smoke, do drugs or drink excessively? Who have they worked for in the past? And do they have a clean driving record? You can't discriminate in employing anyone on a number of these grounds, but they are worthwhile considerations when hiring a new employee.

Will a job applicant be able to keep you and your projects out of trouble? No. But the people you hire are your first line of defense against legal and financial distress. Look at it this way. Find the right person for the job, and you won't have to pick up the pieces when someone louses up one of your projects.

Summary of Part 1: Surviving

We've covered a lot of ground so far, from discussing finding a group of people to help you manage your difficult financial situation, to borrowing money (only to buy time), to stalling creditors to this chapter, where we discussed managing your personal life through this crisis and into the future. What you learned about survival will be the foundation of your future success as a construction contractor. Don't forget those lessons as you read the next two parts of this book. Every sound and profitable construction company, like the house you're building, needs a firm foundation.

Every contractor struggling to survive needs accurate information on his financial situation. When you're in trouble, draw up a financial statement before trying to satisfy any debts. You're the only one who knows the amount of each debt and the value of each asset. If you don't compare debts and assets, you'll never know exactly where you stand. Builders who don't have a current balance sheet get derailed by even a minor hiccup in their cash flow.

Don't dump any hard-earned cash into your debts until your financial statement is in order. Bankruptcy may be the only way out, but a little planning and some borrowed cash could buy you the time you need to return to solvency.

I advised you to rate each debt by priority. Paying off some debts is more important to your survival than others. But every debt has to have a place on your priority list. Setting priorities puts you in control. Once debts are listed in categories according to their ability to bite you, allocate income and assets to each of them as far as possible. Some holdings are more liquid than others and can be used more easily to pay off debt. But, given enough time, all outstanding obligations can usually be met.

Assets that can't be converted to cash easily may still be usable for debt reduction. Frozen assets can sometimes be swapped for debt or can serve as equity for new loans.

"Don't go the bankruptcy route without counsel from a bankruptcy attorney. "

A debt-reduction program might include some new borrowing. Sometimes new loans *do* make sense. But they only transfer the debt and postpone payment. That's not the final answer, but the time helps. Once you've got a bank on the hook, you can do a lot of leveraging. The only long-term way out of debt is to increase profits. Concentrate on reducing costs and increasing profits, not borrowing. And avoid giving a lender any new collateral if at all possible.

Buy time from creditors with promises, trust deeds, auto pink slips, or stock. There are a thousand ways to stall for time. In fact, your creditors can probably suggest some ways you haven't thought of. But staying in touch with your creditors is pretty much the simplest method. Moreover, it's also the cheapest.

Higher profit margins, income conservation, and debt avoidance save construction companies in financial trouble. Nothing else really works. To survive, you have to quit spending, and work exclusively on what's going to yield immediate income.

A good tax accountant is essential to your debt-reduction program. *It's possible to owe taxes even if you didn't receive any cash.* Have three or four checking accounts. Let the bank help keep your accounts straight. Using several accounts sparingly can buy you some much-needed time.

Sometimes, time and borrowing aren't enough to solve your problems. There's just too much debt, and you have to consider bankruptcy. Don't go the bankruptcy route without counsel from a bankruptcy attorney. First of all, you'll have to undergo credit counseling. Even if you avoid bankruptcy, you'll still be facing lawsuits for unpaid bills, for which you'll need the help of a qualified attorney.

Lawsuits have a way of going on and on. Believe it or not, this actually works in your favor when you're broke. Disputes over debts can drag on for years in the courts. Time lost rarely injures the debtor. And the creditor's memory, resources, resolve and finances tend to weaken with time. You could get lucky if enough time passes, as the creditor could go out of business before you do. Helping cause someone else's bankruptcy is nothing to be proud of, but it's part of the business world.

Fighting your way out of debt may require a transfer of assets. That may help you avoid their premature liquidation. Try to use trusts, incorporation, friends and relatives to hide your assets. It may be to your advantage to become technically broke as soon as possible. A contractor who's broke is a protected contractor, one who sleeps easier at night — at least in the short term. But it's no way to run an ongoing business. It's up to you to protect your assets. Nobody's going to do it for you.

If it isn't already, get your bookkeeping in order — we'll spend some time on this in Chapter 6. When you're in financial trouble, sloppy bookkeeping only complicates matters. Do your accounting faithfully and frequently.

Look carefully at your capital equipment costs. How much are you paying each month for the luxury of having your own equipment? Do you use it full-time? If not, it could break you. Unload anything you're not using constantly, and rent it back only when you really need it.

One more note before we head off into somewhat calmer waters. Do you have any partners? Maybe you've got too many. It could be time to lighten the ship. It's hard for a partnership to make decisions. You can go broke before the right decisions are made. If you're going broke gradually, it's easier to maneuver with less baggage. "Don't take on a partner to do what you can hire someone to do."

PART TWO:

STABILIZING

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Bring Some Sanity to Your Business

Now that you've gotten past the crisis stage, let's take some time to look at the fundamentals of the construction business. We'll assume that you've either come to an agreement with your creditors on extended payment schedules, decided to opt for voluntary Chapter 13 bankruptcy or were forced into involuntary Chapter 13. Whatever the means, you've got your creditors off your back for now. So you can take some time to get your house in order and understand how to improve the fundamentals of your business, while laying the foundation for Thriving, Part Three.

"Most bankrupt contractors find that they have to work for someone else for a considerable period of time to re-establish their credit score."

If, on the other hand, you've opted for Chapter 7 or been forced into bankruptcy by your creditors, you may just as well close the book at this point; you're no longer in the construction business, at least for now. And after everything has been settled and you can get back to living your life, my guess is you won't try the construction business again. Most people recovering from bankruptcy find that they have to work for someone else for a considerable period of time to re-establish their credit score, rather than going straight back into business on their own. Few businesses can survive without adequate starting capital, which is the one thing you won't have and won't be able to borrow, for at least two years.

Understanding What Business You're In

You need to know the nature of the business you're in before you can understand why you got into difficulty in the first place. Then you can stabilize your business and get it on sound footing and start to thrive. You've probably heard why railroads failed to maintain the predominant position they once had in long-distance passenger travel. They didn't understand what business they were in. They thought they were in the railroad business, but actually they were in the *transportation* business, and they were just one, even if the major, sector at the time. So when the airlines came along, railroads lost the vast portion of their long-distance passenger business.

Railroad companies had the capital and borrowing power to expand into the airline business, if they'd realized that the airlines were the future of long-distance passenger travel. But they didn't, and so began the decline of the long-distance railroad passenger business. You can probably think of other examples where companies or individuals didn't fully appreciate the business they were in, and so failed to capitalize on the opportunities that came along.

It's important for you decide what business you're in, or would like to be in. Just to say that you're in the construction contracting business is far too broad. There's a lot of competition in the field, and it's difficult to stand out from the crowd. Your product becomes a commodity, and you don't have much pricing power. All things being equal, the customer tends to take the lowest bid if he's looking for some general contracting work to be done. It's difficult to make much money if you have to be the lowest bidder all the time in order to get the contract.

But there are numerous specialties under the construction contracting umbrella. It may pay you to specialize in one particular area, especially one that's hot at this particular time, if you have some expertise in that area or can attain it fairly quickly. There are community college courses and other teaching aids to retrain you, if you so desire. Of course, you'll narrow your customer base by specializing, but you may find it easier to promote yourself if you concentrate on one specialty and gain a reputation for being good at it.

There are numerous upgrades that owners are demanding be done to their homes. You can probably find one that's not catered to adequately in your area, and capitalize on the opportunity. However, beware. These trends can be fads; you'll have to keep your eyes open for the moment when they start to slow down and the next fad begins to emerge.

The Author's Perspective

Before going any further, I'll describe the way I do business so you can understand my viewpoint. I'm a self-employed architect-construction manager by profession. In other words, I make my living by designing and constructing buildings. I've found a niche that's both profitable and comfortable for me.

I should point out, however, that finding that niche wasn't an easy or cheap discovery. As a builder, I've had several people working for me at times. And at other times, it's been just yours truly. Sometimes I made money, but many times I didn't. It seemed that every time I got rolling, along came a recession and took me down with it. So I decided to recession-proof myself. I took a part-time teaching position. The money wasn't great but it was steady and I made a lot of contacts. Next, I got rid of my staff and did everything myself. Then I quit bidding because there was always too much competition.

Now, I build in one of two ways. I build what I design under contract to an owner, with no competition. Or I build projects that are so exotic that everyone else is afraid of losing his shirt. I do these jobs also on a contract basis. I never *closed bid* anything or compete for a job. *I always know how much profit I'm going to make going into a deal.* All my help are subcontractors. I don't carry anybody, ever. I always make money — more of it than I ever did as the typical, bid-on-everything contractor. But I've built a reputation as being good at what I do. It wasn't quick or easy. And I'm not proposing that everyone should do as I do; just that it's worked for me.

"There are more ways to make money in the construction business than you can possibly imagine."

I'm not suggesting that my way is the only way. Others may do just as well or better taking the jobs I reject. The point I want to make is this. There are more ways to make money in the construction business than you can possibly imagine. And there are probably just as many ways to get wiped out. Competitive bidding (against cut-throat competition) isn't the only way to get work. It might even be the worst way.

Many construction contractors and subcontractors have found a profitable niche as I have, and do very well year after year. Maybe you can too. The fact that you're reading this book tells me you want to try.

Before you think of specializing, you must understand the nature of the business that supports both general construction contracting and all its specialties. Let's look at the fundamentals of the construction contracting business.

The Basics of Construction Contracting

Construction contracting may be the quickest way to make money legally. Many contractors have doubled and redoubled their assets in a short period of time. It takes skill, luck, hard work and long hours, but the rewards are consistent with the risk and effort. Where else can you start out with a few tools, a truck and no particularly special skills and build a multi-million dollar business in three or four years? It's been done many times in construction.

Even if you don't make a fortune, construction contracting is satisfying work. You work outside, have only yourself for a boss (that is, unless you're working for a direct customer — he's always the boss), and can take pride in providing durable and attractive shelter.

But construction contracting is also complex and demanding work. Even a simple project requires coordination of many different tradesmen and types of materials. Running a construction project (or a construction company) is like driving a team of spirited horses that want to go off in every direction at the same time. Anyone successful at construction contracting is likely to be a jack-of-all-trades and the master of most of them — a sort of man for all seasons. A builder/contractor has to be a salesman, accountant, collection agent, labor negotiator, planner, plumber, laborer, estimator, marriage counselor, electrician and carpenter, all rolled into one. If you come home tired at night, it's not surprising. Just one or two of these jobs would be enough for most people.

Should You be a Construction Contractor?

Before going any further, ask yourself this one critical question, "Should I be in the construction contracting business?" How did you get into this business? Did you drift into it because nothing else interested you? Did you back into it because your father or uncle was a builder, and you spent your summers working for him? Or did you become a contractor after some thought and planning?

If you didn't give it any thought before, you should now. Construction contracting isn't for everyone. The best framer or finish carpenter in the world may make a very poor construction contractor. There's much more to contracting than just construction skills. If you can't estimate costs, sell the job, get a loan, maintain the books, collect bills, and keep your clients, employees and building inspector happy, your carpentry skills alone won't make you into a successful construction contractor. Maybe you'd be better off working full-time as a carpenter and leaving the office work to others.

Ask yourself a few more questions. Do you like accounting? Can you at least tolerate it? Everyone who runs a successful business creates and uses good financial records. If you hate paperwork, you'll never like contracting.

Can you work with clients, associates, subcontractors and employees? Construction is a people-oriented business. If dealing with others isn't your strong suit, contracting isn't your vocation. You'll probably be happier doing something else.

"If you hate paperwork, you'll never like contracting."

Contractors also need a high tolerance to stress, and a certain air of confidence and authority. I think of my job as being like the lion tamer at the circus. I work with some pretty independent and aggressive characters, in situations where there's a substantial risk of loss or injury. A mistake in a careless moment can lead to disaster. But because I've rehearsed my act carefully, I don't expect there to be many surprises. And I've noticed that giving an impression of confidence and authority promotes cooperation and compliance in those I work with. If you don't thrive on stress and don't convey an appearance of confidence and authority, maybe contracting isn't for you.

If you do get into difficult financial circumstances, you shouldn't take the demands of others too seriously. There are few real life-and-death situations in a construction business. No one is going to shoot you or lock you up for being in debt or losing money. In fact, you can probably beat or delay any creditor. Losing your nerve will just encourage those who want to take advantage of your misfortune. There's no need to panic, however stressful the situation becomes.

Your Attitude

It may seem irrelevant to worry about attitude when you're fighting for your economic life or struggling for more profits. But I can tell you from my own experience that unless you believe without question that you'll succeed, you'll never get very far in the construction business.

Your attitude influences how your clients view and judge you. If you come across as a negative, overburdened, marginally-successful builder, you'll only get the left-over jobs that other contractors have turned down.

Property owners who have the money and borrowing capacity to put up a building or develop a plot of land usually have something in common. I've found that they're successful, productive, practical people with a positive outlook on life. They like to work with other successful, productive, practical people. They want to deal with contractors they trust, understand and like. And they're reluctant to work with those who seem to have different values and standards.

But don't misunderstand what I'm saying. Many characteristics can offset a lack of financial resources. And prime among these are two that cost you nothing — a positive attitude and self-confidence.

Having a positive attitude is a very important part of your business. It's the first thing your client sees and the last thing he'll forget, long after his project is finished. Let a positive attitude be a major asset of your company, even if its financial assets are a little skimpy.

Communication

Good communication is essential for every contractor. Some contractors have a tendency to ignore their clients, their creditors and their problems whenever possible. That's a very poor policy. Problems don't go away by themselves. They require attention, consideration and resolution. Above all, they require communication.

If you ignore your clients' phone calls and correspondence, you leave them with no alternative but to come and find you. Ignoring a client's call creates a problem in itself. Even if there wasn't really a problem before, there is now. You may think that you're buying yourself time by not returning a call. But the right attitude and good communication can win you weeks (even months and, in some cases, years) of delay if needed, especially from creditors. So don't ignore your clients. Talk to them. You may have many unpleasant discussions and you'll need a thick skin, but the alternative may be even more unpleasant, time-consuming and costly.

A Word About Profits

Remember the apple sellers — volume alone doesn't produce profits. At least 10 percent of all construction projects are potential money losers. When you come across one of these 10 percent, turn it down and walk away. Low-profit work wears you down without producing an acceptable return.

You always work three times for a profit — once to find and land the job, once to do the job, and once to collect the money you've earned. Just because you've performed the first two tasks, don't assume that the third one follows automatically. It doesn't. You have to protect, cultivate and collect your profits before they ever reach your checking account. Otherwise, you'll never take them home.

Profit-making is like popping corn. For the best results, don't take your eye off the pan. Keep things in motion from the time the pan hits the flame until the last kernel bursts. Keep your projects moving the same way. Watch your profit on each job constantly. Cultivate and protect that profit until the work is complete and you've collected the final payment. *Making a profit is the only reason you're doing the job.* Don't ever forget that.

Don't take jobs from owners who want you to work for minimal or no profit. Tell your clients right up front what their project will cost to build and what your fees are. Be friendly, honest and firm on the issue of cost. Some will respect you for it. Others may be offended. You can survive and even thrive without the latter group. So let them go.

Building a reputation as the lowest-priced contractor in town will only wear you out physically and emotionally. Pick and choose your projects. Do quality work for owners who want to rely on a reputable, competitive and competent builder.

All of this assumes that you have a choice in the jobs you select to go after and bid on or negotiate with the owner. Unfortunately, in the early stages of your business before you've established a reputation, you may not have the luxury of picking and choosing jobs. You may have to fight for any job you can get and do your very best to make a profit at it. This is your opportunity to learn how to run a successful project and to start building a good reputation so that, in the future, you'll have more of an option to select the projects you'd like to work on.

Unfortunately, there's another situation when you may not have an overabundance of jobs. That's when the national or the local economy has gone into the tank and everyone is scrambling for whatever pickings are still around. This happened in Southern California during the early-to-mid '90s. Even though the national economy was relatively strong, the local economy was terrible. This was because of major cutbacks in defense spending, with the White House and Congress trying to capitalize on the peace dividend. Since Los Angeles and San Diego were very dependent upon the defense industry, there were no jobs to be had. People were leaving the area in droves and, of course, no one was building houses or upgrading their present homes.

Eventually the Southern Californian economy turned to various high tech industries, such as biotech and semiconductors. The tide turned, and by the beginning of the new millennium, the area was starting to hum again. However, in the meantime, we all had to learn to cope with the dreaded "r" word: recession.

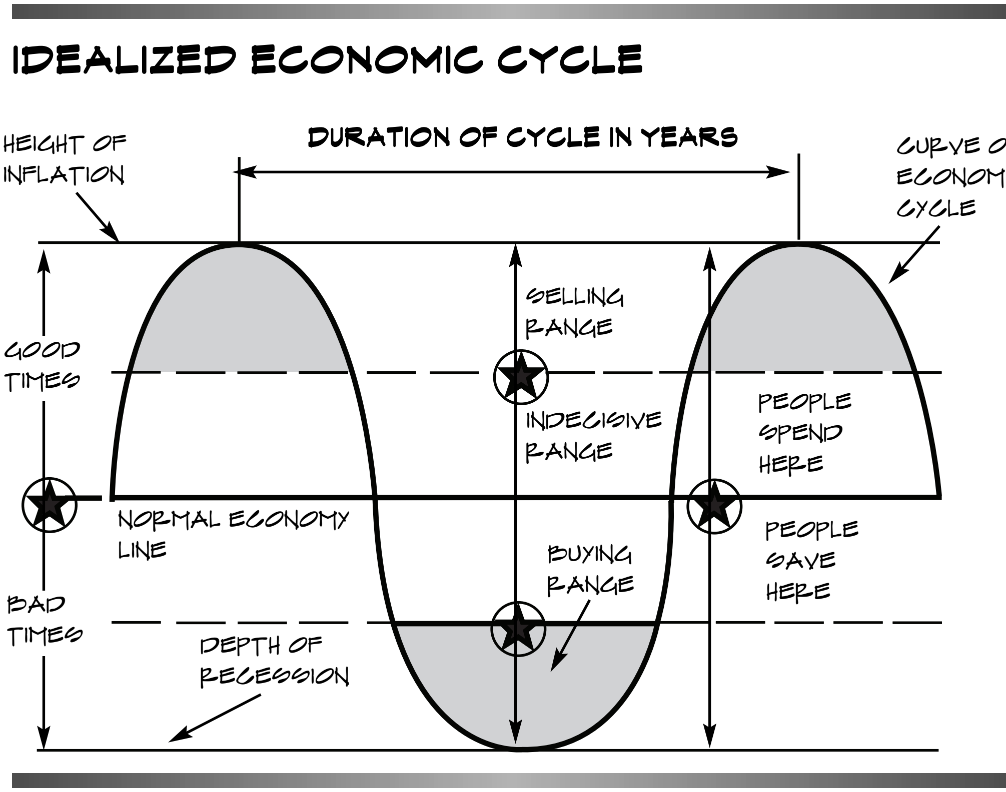
Coping with Recession

Every construction contractor should understand that there's a cycle of construction activity. This cycle rewards those who can anticipate it and punishes those who can't. The construction cycle can make or break you. And for many it does both, in quick succession.

At the beginning of every upswing in construction activity, a fresh new crop of eager young builders surges into the industry. They build a house or two, sell them off at a nice profit, and then tackle larger projects, making more money and making even bigger plans. After three or four very profitable years, some of these builders are running big construction companies with millions of dollars in revenue and several major projects under way. They probably attribute their success to hard work, skill and daring. They're right. But they were also in the right business at the right time. Unfortunately, the good times don't last forever.

When recession comes, as it surely will, you'll find that hard work, skill and daring count for very little. The bank loans, heavy investment in materials, equipment, staff, overhead and completed projects that now can't be sold become a crushing burden. Many builders fail and leave the business altogether. Others can salvage enough to remain active or at least stay open for business until the next upswing in the economy.

There's no reason to suspect that our economy will be better managed or that recessions will be less frequent in the future than they have been in the past. Accept the ups and downs in construction activity as an opportunity to improve your competitive position against other contractors. Plan to survive when others can't, and to thrive when others are only beginning to recover.



Idealized economic cycle
Figure 5-1

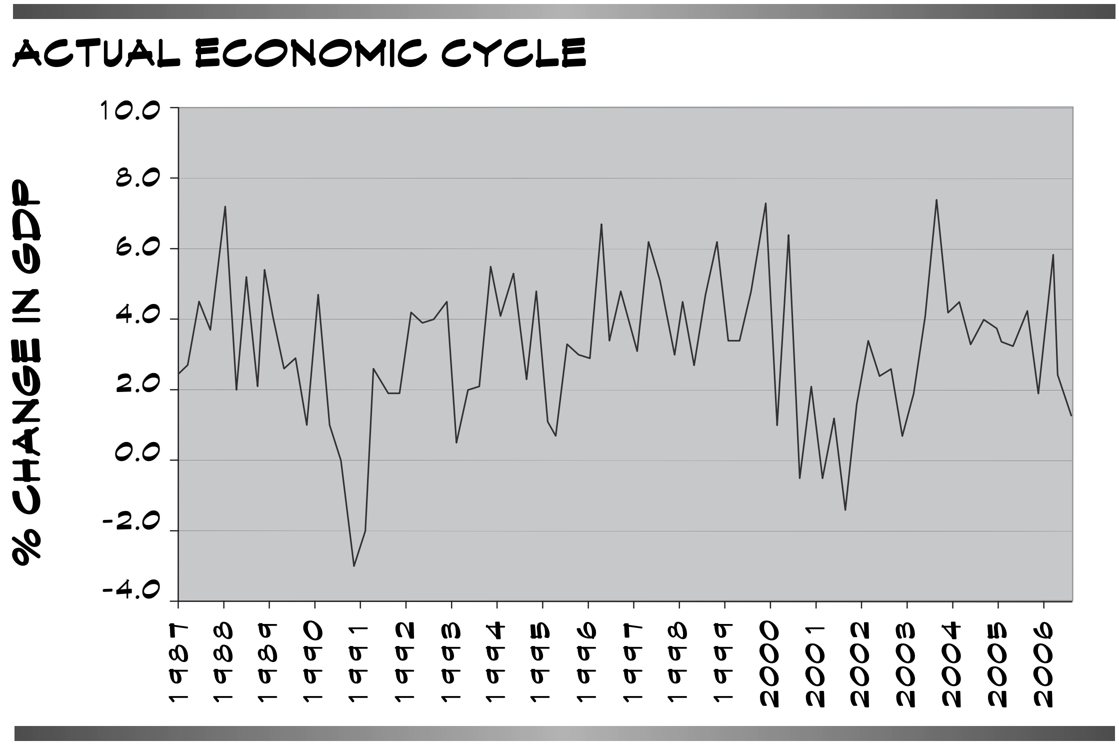
Exactly what is a recession? From a builder's standpoint, we're in a recession when construction activity is below normal. That's usually because owners can't borrow money, or would have to pay interest rates that make borrowing unattractive. Nearly all construction work is done on borrowed money. When lenders stop lending, builders stop building. That's a recession.

To survive more than one cycle in construction, you have to anticipate the business cycle. It isn't all that hard. Like the seasons, they tend to occur at regular intervals. Anything that's fairly predictable can be planned for. And planning is the only way to make your company recession-proof.

Later in this chapter, we'll look at how planning can help you use the construction cycle to your advantage.

Plotting Construction, Business or Economic Cycles

You can't anticipate the construction (or business or economic) cycle until you know how the cycle works. So let's look a little more carefully at the construction cycle or *economic cycle,* as it's often called. Figure 5-1 shows an idealized economic cycle of rising and falling business activity. I've simplified the cycle to help you recognize the various phases.



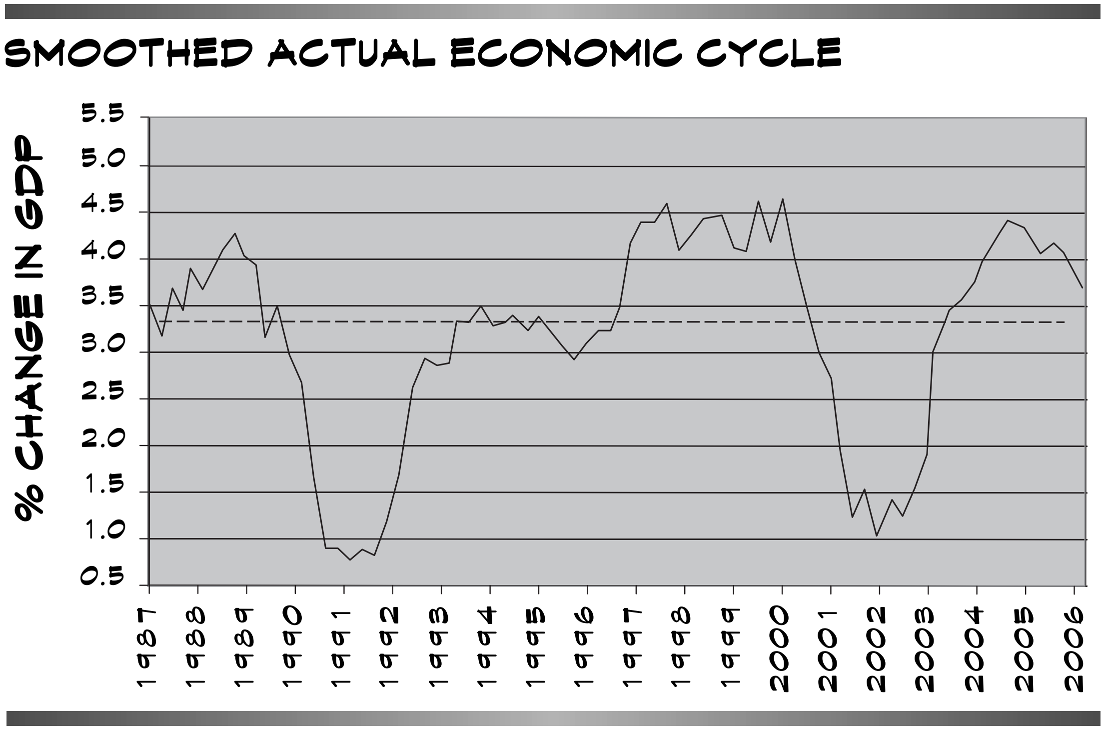
Actual economic cycle
Figure 5-2

There's a definite trend during each part of the cycle. And what's going to happen next is quite predictable. Timing is the major unknown. The overall shape of this idealized cycle is a smooth continuous curve from a peak of inflation to the bottom of the recession and back again. Since this curve is smooth and consistent, you'd have little trouble planning major business decisions around it.

Recessions — The Big Picture

The actual business cycle, Figure 5-2, is a lot less predictable, as you might expect. However, despite the fluctuations, there's still an overall cyclical nature to the curve, with major dips in the 1990-91 and the 2000-02 periods, as you probably remember all too well. Don't worry about the small fluctuations in the curve. It's only important that you identify the larger, slower changes in direction. The small monthly fluctuations matter only to stock traders and commodity speculators. As a builder, you're in a much longer-term business. You can't do much building in less than six months, so short-term fluctuations don't really affect you.

The major fluctuations in the economic cycle are a lot more obvious if we take a two-year (eight quarter) rolling average, which smoothes out the minor fluctuations, as shown in Figure 5-3.

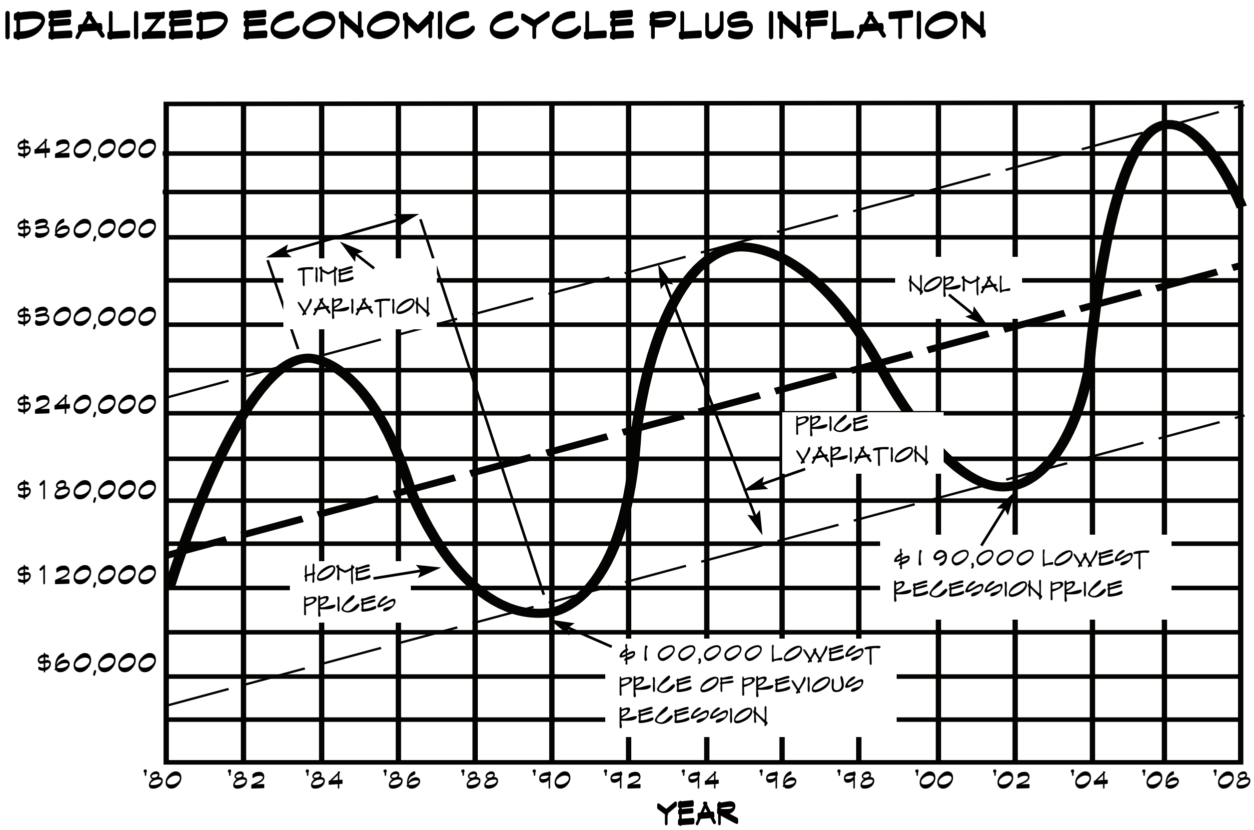


Smoothed actual economic cycle
Figure 5-3

So in order to predict the future economic cycle, you need to identify whether we're presently in the recessionary or inflationary phase of the cycle. If we average the quarterly percentage Gross Domestic Product (GDP) changes over this 20-year period we get a figure of just over 3 percent. We can take this as the equivalent of the Normal Economy line in Figure 5-1. After the long recessionary period of 2000-02, the beginning of 2005 was well above the normal economy line, in the inflationary part of the cycle. And if the typical sinusoidal curve of the past 20 years is to be followed, you would have to expect that we're presently approaching the top of the cycle once again. So we can expect that the curve will start to trend down and we'll enter another recessionary part of the economic cycle.

The only question is the duration of the next cycle. Will it be 10 years as the last cycle was or more like five years as many economists are suggesting? With the present pending housing bubble and the high price of oil, it's beginning to look as though the economists are right.

In addition, you should note that the overall trend in the economic cycle is generally upward or inflationary. For example, the lowest price of a home during the 2000-02 recession was considerably higher than the lowest price of a similar home during the 1991-92 recession. So if we add an inflation component to the economic cycle we get an idealized graph like Figure 5-4.



Idealized economic cycle plus inflation
Figure 5-4

In Figure 5-4, you can see that the price of a home at the bottom of the recession in 1990 was $100,000. The price of a similar home at the bottom of the recession in 2002 was $190,000. That's $90,000 more than in 1990, representing $90,000 inflation in values, even though the construction business was in a recession in 2002.

The point of this is to show that house prices tend to increase from recession to recession. So even if house prices fall significantly in the next recession, count on them to rebound once more to new highs within a few years. That's just the nature of the housing cycle. Knowing that should give you courage to hang on to assets when others are liquidating.

The real danger for builders and developers is that they'll be forced to liquidate at the bottom of a recession before the economy has recovered. Contractors who don't have the cash to make interest payments when they're due have to sacrifice assets to satisfy creditors or face foreclosure. A forced sale at the bottom of a recession is never good for the seller. And most important, it strips the contractor of the assets most likely to increase in value during the next upswing in the economic cycle. Try to have enough reserves to hold on during a recession and you won't be forced to liquidate at fire sale prices.

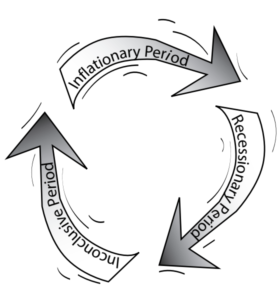
Planning for the Economic Cycle

So much for the way the economic cycle works. Now let's take a look at the investment and business decisions that you should be making in each phase of the cycle.

How do you plan for this cycle? That's easy. Keep your thinking half a step ahead of the economic cycle. Start to think about the next recession when construction activity is at its most intense. And turn your attention to the next boom when recession is driving panic-stricken contractors to the wall.

When every carpenter who can drive a straight nail is working full time, begin thinking about what you'll do when the work in your business is less than half its present volume. How will you cut overhead by at least 50 percent? What projects will you close out as construction activity declines? Who are you going to lay off? What salary adjustments will you make? Can you shift emphasis away from speculative building to remodeling, additions or government jobs if more work is available there? Maybe you can get work on a cost plus basis at a slim but guaranteed profit while others battle it out over the lowest bid jobs.

Start building a financial cushion of spare cash (survival money to use when every dollar counts). For some builders, it would be better to close up shop entirely for the duration of a recession. That's a real option. It may be better to close out your projects, pay your bills, furlough your employees and go back to teaching school or working for your Uncle Fred for a while.

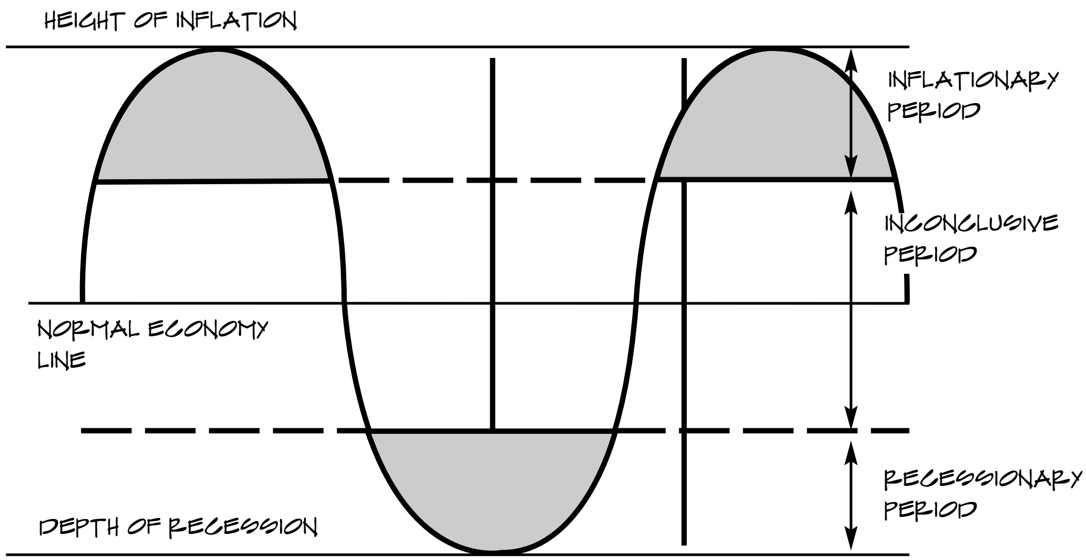


Most of all, plan to reduce risk by reducing the money you owe. It may seem obvious but it's something to remember — only debtors end up in bankruptcy court. If you don't owe any money, you'll never go belly up. *Debt-free builders don't have to take zero-profit work just to stay busy.* They can put the business in mothballs or continue at very low levels of activity until better times return.

And you can be sure, better times will return. Start planning your revival at the depths of the recession. When others are being forced out of business, look for land or other properties that don't seem attractive at the time but that have profit potential when buyers come back into the market. Start working with investors or lenders who will finance your growth during the next boom.

Decide what type of work you want to handle during the coming upsurge and prepare yourself and your organization for that day. Assemble your team and your resources for the next boom, at least on paper. Commit yourself and your finances, as heavily as you dare, to one key project or one opportunity that's most likely to succeed when business revives. That's an excellent prescription for building a thriving business in the next upswing of the economic cycle.

INFLATION/RECESSION PERIODS



Inflation/recession periods
Figure 5-5

Remember this throughout the economic cycle — things are never quite as good, and never nearly as bad, as most people perceive them to be. Don't let the emotions of others keep you from using the economic cycle to good advantage.

For our purposes, we'll divide the economic cycle into three phases. See Figure 5-5. The top section we'll call the *inflationary period*. The bottom section is the *recessionary period*. The remaining or middle section we'll call the *inconclusive period.*

There's a saying among developers that goes like this — "When others figure out what you're doing, it's time to switch to what they're doing." There's a simple truth here. Smart money moves in and out of the real estate and building markets as the economic cycle moves from inflation to recession and as the buying public reacts to inflationary and recessionary pressures.

The principle is so simple that most people miss it completely. If you plan to do next year what was generally accepted as good policy for this year and last year, you're probably planning to do the wrong thing. There's a good time to invest and a good time to sell. If you buy when buying is considered wise by the general public, you'll end up buying high and selling low.

"...smart money moves in and out of the real estate and building markets."

And, strange as it may seem, there's a time to get out of the market altogether. And it's not when everyone else is selling. When everyone else is selling, the really smart money has already sold out long ago. The time to liquidate, or to at least reduce your investment in real assets significantly, is while there are still enthusiastic buyers left in the market. This may seem difficult to do psychologically, as you always think the market may go higher. And perhaps it will, but the smart move is not to be greedy and to be satisfied with the gains you've made. And if you miss out on gaining a little more, that's a lot better than losing a large amount if the market turns faster than you were anticipating.

When the recession is nearing bottom, when projects are being liquidated to satisfy creditors, the smart money is picking up the choice assets that will be the first to recover when the economy revives, as it inevitably will.

The remaining part of the economic cycle, the middle part, is what we called the *inconclusive period*. Neither inflation nor recession is predominant. There's no clear trend, or the trend may be in the process of reversing.

This inconclusive period is a good time to take stock of your position. It's a time to look seriously at what you've accumulated and weigh your options. It's a time of transition. Restructure your thinking and reposition your assets from defensive to offensive, or vice versa. Few contractors recognize the need to make business changes during the inconclusive period. Others see the need for change coming but don't make enough changes in time.

As I suggested earlier, the smart money moves in and out of the real estate and building markets. Think back to the late '90s. We were in a red-hot real estate market. Builders could do no wrong. What some in the construction business didn't realize was that we were cresting that particular inflationary cycle. By the early 2000s, the *dot.com* bubble had burst and, particularly in Northern California where the effect was felt the worst, construction work stopped and the economy pitched over into a recessionary slide that few were prepared for.

Look again at Figure 5-3. Notice that the economy had already begun to lose its momentum by the middle of 1987. This was a warning sign of what was going to happen in the upcoming months and years. It was a sign to builders to conserve cash, postpone investment in additional equipment and real estate, and to reduce staff until the next economic cycle began.

But few did. When the cycle turned down in 1989-90, I watched builders, plumbers, suppliers and owners alike pushed to the brink of financial ruin. I laid off my staff of eight, could find very little work for months, and ran up $100,000 in debts. At the bottom, I was beginning to lose hope of working out from under these debts. No one knew how long the recession would last. Luckily, I had planned for it and I was able to stick it out. I had to. There was no other way for me to pay off my debts.

You have to understand that timing is critical. No contractor can run his business as though the inflationary cycle will last forever. It never does. When the economy starts to slow down, just get out of the way. You don't have to be taken down with it. Then lay your plans for the recovery. *Be ready to start new ventures when you're at the bottom of the recession, not the top*. From the bottom, the prospects can only get better.

But how do you know if the economy is at the top of a cycle or at the bottom? Unfortunately, it's not always easy. As I illustrated in Figures 5-2 and 5-3, the actual economic cycle is a rather rough curve, not the smooth wave as suggested in Figure 5-5. Even in retrospect, it may be hard to pick the exact bottom or the exact top. Fortunately, that isn't necessary. It's only critical that you identify an inflationary or a recessionary period when you're in it. Each period lasts approximately 12 to 24 months. You have plenty of time to make up your mind.

If we're in an eight-year cycle, such as the period of 1997 through 2005, you have two years in an inflationary peak, two years of downward sliding through an inconclusive period, a two-year recessionary bottom, and finally two years of upward rising through an inconclusive period before the next two-year inflationary period. The really critical periods are the shaded areas at the top and bottom of the cycle. See Figure 5-6.

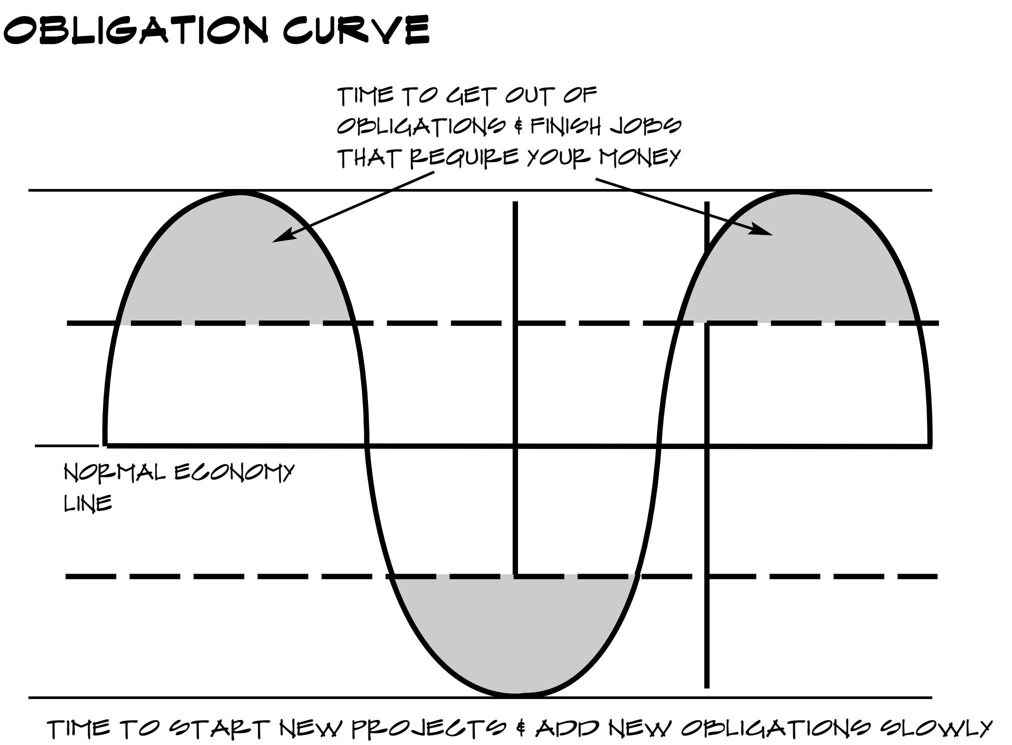
Let's say that you've been watching the economic trends. You feel pretty sure the cycle has peaked and will soon start to head downhill into a recession. Now what? Well, it's time to wrap up any projects that are draining cash out of your bank account. Get out of debt now, before buyer enthusiasm has disappeared and bankers begin to get cautious. It's time to switch horses.

Switching Horses

Switch horses before the inflationary bubble bursts. Stop building speculative houses. That market is about to collapse. Start bidding more work for other contractors. Go to work on someone else's money, not your own. If you wait until the recession is in full swing, the pickings will be slim. Too many contractors will be bidding for what little work there is still available. Make the switch months ahead of when you actually need the work. Don't wait until six months after the need arrives. That's too late.

Suppose you're in the opposite situation. You feel the recession has just about bottomed out. Now what? It's time to begin those new projects you've been planning through the last 12 to 24 months of down sliding. But begin slowly. There's no rush. *Remember, it's better to get into the market three months late and get out three months early than to get trapped in a negative market with assets that can't be sold.*

As the economy strengthens, put less emphasis on contract work with others. This gives you more time to devote to your own projects. But don't withdraw completely from the contract market. You'll probably need that



Obligation curve
Figure 5-6

type of work again in a few short years when the upward momentum of the new economic cycle is slowing. So again, don't burn those bridges — you'll need them in the future.

The kind of work to emphasize should be based on your evaluation of economic conditions. Keep your workload in tune with the economic climate. If the economy is beginning to expand, gamble a little. Take some short-term risks. Speculate by building a house or two, even a small tract of houses or a commercial building.

But if the economic cycle is shifting downward, it's time to change tactics. That doesn't mean closing down the business necessarily. Just avoid jobs that require a big investment. Go to work for others who are willing to risk their own cash, so you don't have to risk yours. And do it before others recognize the trend in the economy.

To avoid stumbling into a financial crisis again, strike a balance between speculative work and work you do for others. The quantity of each type should change as the economy changes. If you're doing 75 percent speculative work for yourself in inflationary times and 25 percent for others, reverse these percentages when the economy starts to hit the skids. That maximizes your reward in good times and minimizes your risk in bad times.

This risk-taking isn't gambling. Gambling is tempting fate. It requires neither planning nor forethought. Risk-taking is a deliberately planned and carefully executed action. Only take risks when all the options have been fully explored, the possible losses evaluated, the time limits established and the money set aside. There should be little, if anything, left to chance. Take risks when the odds are in your favor, like the dealer in blackjack. You may lose a hand or two, but over many hands you're going to come out ahead.

By now, you should see that trying to continue doing business the same old way in both good times and bad can break you. Recognize the economic cycles. Learn when to start your projects and when to close them out. You'll increase your profits and reduce your risk of loss substantially. Switch from speculative building for yourself to working on contract for others when that seems advisable. Believe me, you'll save yourself a lot of time, money and headaches.

We've spent quite a lot of time learning about the longer-term aspects of the construction business, so now let's turn our attention to some of the short-term considerations that will help you stabilize your business and prepare it for the Thriving stage.

Cash Flow, Conserving Income and Avoiding Debt

Contractors live and die by their cash flow: the money coming in and going out every day. Even if every penny that comes in has to be paid out again the same day, a construction company can survive for years in apparent prosperity. But that isn't unique. A family, a small business, a large corporation, a city, a state or even a country can operate quite successfully, even though fundamentally bankrupt, so long as the amounts of money coming in and going out each day are roughly equal. However, under conditions like this, even minor fluctuations in cash flow can be a cause for serious concern — but don't panic. It may give you some stressful nights, but probably won't cause the house of cards to collapse, if you handle things correctly.

Builders with a cash flow of many millions of dollars a month have survived with liabilities equal to their assets. So long as each outgoing dollar is balanced by a dollar of income, they're doing just fine. But if income is one dollar and outlay is one dollar and ten cents, there's a problem. That's called *negative cash flow*.

"Builders with a cash flow of many millions of dollars a month have survived with liabilities equal to their assets."

Let's say that you have an income of $40,000 a month and expenses of $36,000 a month. Your profit before tax is $4,000. But your business needs a new rig that will cost $200,000, including interest payments. Your plan is

to pay for it out of profits over the next 50 months at $4,000 a month. That's four years and two months of going without a profit, assuming that the new rig doesn't improve your profitability (which hopefully it will, or why would you buy it — but for this exercise we'll just assume that it doesn't).

You think the future of the business looks good so you go ahead and make the purchase. A little while later, unexpectedly, income drops off to $30,000 a month and remains there for the next two years. That's the normal economic cycle, as we've just seen. Expenses remain at $36,000 a month and you still have to pay $4,000 a month for the new rig. So now you're losing $36,000 - $30,000 = $6,000 plus $4,000 (for the new rig) for a total of $10,000 per month. At the end of two years, you're in the hole for $240,000.

Hopefully, by some miracle, you're still in business when the economic cycle swings upward again. The new equipment is nearly half paid off. Income is back to $40,000 a month and expenses are still at $36,000 a month. But now you've got $240,000 in additional debt. Interest on that debt is more than $1,500 a month, leaving only $2,500 a month available for payments on the rig, rather than the $4,000 you have been paying. So you refinance the equipment to lower your payments to $2,500 a month for the next 40 months.

Unfortunately, we must assume that prosperity won't last that long. It seldom does. Long before the rig is paid off, income will drop off again and another loan will be needed. Even if the rig is eventually paid off, it will take you maybe five years to dig out from under the $240,000 debt load.

The moral of this exercise is clear: Don't take on large debts unless you can pay them off in a relatively short period of time, either by selling the land or property you bought and improved before sale, or by taking out a short-term loan for capital equipment. If you can't afford the monthly payments on a short-term loan, rent the equipment when you need it and avoid the debt altogether.

Dependable cash flow is an enormous asset to any contractor. Unfortunately, very few contractors have it. Fluctuating cash flow can be disastrous in an under-capitalized business. The more limited your cash reserves, the more important it is to keep income and expenses in proportion.

If your expenses are roughly the same every month, even a slight dip in income may be difficult to handle. If income drops for several months in a row, you're in a cash-flow crisis that may be fatal to the business. If cash flow goes up and down like a roller coaster, you may have difficulty surviving even when business volume is climbing and the work is profitable. Most builders would be better off with a smaller but more dependable cash flow and the accompanying smaller revenue and lower expenses each month.

The best strategy is to develop a steady cash flow on work that's consistently profitable. Then gradually increase the work load that's producing the profits, if possible. If not, recognize that a small cash flow isn't necessarily bad. Bigger isn't always better. But a large fluctuating cash flow is always tough to handle and is probably less profitable than a smaller but steady one.

Of course, the correct reaction to reduced cash flow is to reduce expenses. But that isn't always easy. Material and on-site labor costs tend to vary in proportion to income, referred to as *variable costs*. But overhead, such as office space, office staff salaries, equipment, etc., so-called *fixed costs*, varies very little, and is generally much harder to reduce. And loan payments may not vary at all, even if business falls off to little or nothing.

One expense that can be cut quickly is your own salary. It's never pleasant, but taking less for your services as manager of the operation may help your business survive until prosperity returns. When the time comes to think about cutting overhead, you have to look seriously at your own living expenses. You'll often find that major savings are possible, even though they may be painful.

Summary

This chapter covers some of the basics of the construction business that should be understood by general contractors, builders, subcontractors and the self-employed entrepreneurs who handle most of the construction work in this country. Whether you're just getting started in construction or have been bidding jobs and meeting a payroll for years, you need to understand the basics of the business you're in. Whether construction is your full-time occupation or your "other job" while you draw a salary on someone else's payroll, you have to master these basic principles if you're going to run a stable and ultimately thriving construction business.

Contracting is demanding, complex work. There's so much that can go wrong. You have to wear many hats and maintain a positive attitude. Remember that clients prefer upbeat people and that communication is very important. Don't ignore your clients. Talk to them. Tell your clients right up front what the costs will be and what your fees are. They'll respect you for it.

If you expect to survive in the construction business, learn to adjust to the economic cycle. You can't keep doing the same old thing in the same old way all the time and expect to survive. Be prepared for change. Study what's happening to the economy. Adapt your business activity to the economic times. Live on the money for supervision in your estimates. Use the overhead money on your projects to pay the office expenses. And use profits to pay any outstanding bills. Don't transfer debt from project to project. Pay your current outstanding obligations first — and only out of profits. Don't fall into the volume trap. If you're losing money, just taking on more volume won't cure the problem. Don't play super-contractor. Trim your overhead — avoid the frills.

Once you've figured out the economic cycle, eliminated excess overhead, finished the jobs that were losing money and finally started to turn a profit, take some advice — don't get carried away with yourself. Some contractors try to grow out of what they do best. Specialize in what makes money for you. Experiment if you must. But keep the experiments small and under control. Abandon what doesn't work for you. Get profitable and stay profitable. You'll soon have your finances, self-respect and peace of mind well in hand.

Dependability and profitability are the keys to managing cash flow. Large cash flows aren't necessarily better, especially if they involve extreme fluctuations. Settle for a more modest but also more dependable cash flow.

Who's Minding the Store?

Someone has to actively run the engine room of a construction business if it's going to survive and thrive. Somebody has to tend to the office duties to support the work that's being done on the job site. Paperwork and bookkeeping are as integral to construction contracting as concrete and lumber. A builder who doesn't appreciate this would be better off back at the construction site as a tradesman or foreman rather than working as a contractor.

My initial emphasis in Part One was on doing just an adequate paperwork job, with the least possible amount of effort and time. Adequacy was sufficient when time was in short supply and you were trying to dig yourself out of a hole. You didn't want to spend one second, or one dollar, more than necessary on paperwork while you were trying to survive.

However, hopefully, you've now survived the crisis and are trying to get your business stabilized. It's time to get your accounting system onto a firmer footing, so that when business is thriving you'll be able to manage the bookkeeping with the minimum of effort. So if you don't already own a computer, it's now time to get one, and to learn how to use some of the basic programs necessary to run a successful construction business.

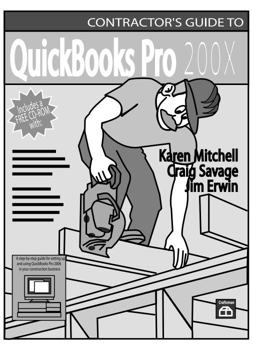
Accounting Using a Computer

Fortunately, computer hardware is now remarkably inexpensive considering the capability it provides. Even a fairly basic system may be good enough for your needs. For less than $1,000 you can get a very adequate system for basic record keeping and estimating. On the other hand, if you want to do some design work on your computer, or would like to carry it with you on to the job site (which means that it needs to be a laptop), a top of the line system may cost you a few thousand dollars.

There are plenty of people available to advise you what type of computer system you should get, if you just tell them what you want to do on it. And there are plenty of computer training programs and community college courses to teach you how to use the basic software. When I was in college, the personal computer hadn't even been invented, so I had to teach myself how to use a computer. Never having had a formal lesson in my life, I now feel fairly proficient, though it's taken me a few years to reach this status.

You can also teach yourself as you go, but I wouldn't recommend it — it's not very efficient. You need to get up to speed as quickly as you can, and not waste a lot of time learning by trial and error, as I did. So sign up for a few lessons at your local community college, and you'll be surprised how quickly you can master the basics you need to get you going.

Fortunately, there are a number of accounting programs that will enable you to manage your bookkeeping and accounting efficiently and effectively. The most widely used of these programs for small construction businesses is *QuickBooks Pro*, published by Intuit, which you may be familiar with for their highly popular *TurboTax*® tax preparation software.



However, *QuickBooks Pro* is a general accounting program. Because it's designed for use in a whole range of different businesses, with many different options, the initial setup can be difficult and time-consuming. Craftsman Book Company, publisher of this book, also offers *Contractor's Guide to QuickBooks Pro*, a manual that takes you step-by-step through the setup and use of *QuickBooks Pro* in a construction business. A CD provided with the book includes a sample company file, with the setup options for a construction business already done. Instead of having to plow through the entire setup procedure from scratch, you just open it and enter your own company data. You'll find more details on the order form in the back of this book. The CD doesn't include the actual *QuickBooks Pro* program, so you'll need to buy that first. Let's just take a few moments to look at the basics of running the accounting side of your business. This will help you understand what it is you're trying to achieve with your computer system.

Getting Started

This chapter is intended to give a very brief, once-over-lightly view of some of the basics of an accounting system. Again, there are hundreds of texts on accounting, and there's no way to cover the topic thoroughly in one chapter. There's a basic accounting book described in Appendix 4 that I can recommend.

Unless you're a professional accountant, accounting isn't any fun. In fact, accounting ranks alongside a root-canal job on many people's list of things to avoid. Unfortunately, it comes with the territory when you're running a construction business. If you don't like accounting or can't at least learn to tolerate it, you're always going to have trouble running a construction company.

"Accounting helps you anticipate problems and avoid trouble before it arrives."

The advent of computers and easy-to-use accounting programs has made life simpler for those of us who really aren't fond of paperwork, and would much rather be out there doing something useful. Well, you're about to find out that the accounting side of the business is in fact very useful. And the more you learn, the more you'll realize just how important it is. It's a well-known fact that in many companies the accounting department actually makes more money for the company than the operations side of the business does!

Fortunately, it's not necessary to be a CPA to use the available accounting programs. It's not even necessary to grasp the concept of debits and credits, which can baffle even the most logical mind. Provided the entries are made into the correct accounts, the software will take care of the math, and produce all of the reports that you can ever imagine needing.

It's important to remember that *few contractors ever went bankrupt with good records*. Accounting helps you anticipate problems and avoid trouble before it happens. That's the power an accurate Balance Sheet and Income Statement can have.

It's more important that your books are kept up-to-date than that they meet every conceivable accounting standard. Business success depends on knowing exactly where you stand financially at any given moment. Make the entries, daily, on your computer. Just make sure they get done, and that the entries go into the correct accounts. Don't put all of your paperwork in a big pile and hand it to your accountant to sort out. He only needs your records for quarterly reports, periodic filings, and year-end tax returns.

Whatever you do, don't put it off. That's the worst possible thing. If you let your paperwork go unattended for a week, two weeks, or a month, you won't remember where the money came in from or how it was spent. *Any income that you can't show was spent for a legitimate business purpose is considered taxable income to either you or your company. So unless you enjoy lengthy discussions with an IRS agent, it's probably best to stay current on your bookkeeping.*

If someone else makes your account entries for you, it's important that you write the correct account number on each check, invoice, or other piece of paperwork that you generate. This raises the question, "where does this list of account numbers come from?" The answer is that you have to generate it. It's called a *Chart of Accounts*. Every business is slightly different, and the way you want to see your reports presented will affect the way you set up your Chart of Accounts.

Setting Up a Chart of Accounts (Part 1)

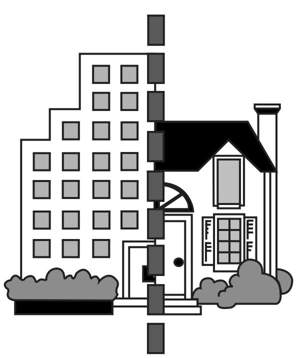
A Chart of Accounts is like a filing system, except in this case it's a simple numeral listing of all of the types of accounts that you might want to keep track of. For example, if you think it's important to keep track of the amount you spend on postage and delivery, you'll set up an account number in the *Overhead Costs* section called *Postage and Delivery*. On the other hand, if you don't think that level of detail is important at this stage, you can have a broader category into which you put all your general office expenses. If you find later on that you need more detail of where your money is going, you can always refine it. I'm sure you feel that you already have a fairly good idea of where your money is coming in from. It's where it's *going* that you need to keep a very close eye on.

A Chart of Accounts is a hierarchy of numbers, typically based on a 4-digit numbering system, though some larger corporations may use 5-digits. The basic account types are:

1000 - 1999	Assets, current and fixed
2000 - 2999	Liabilities, current and long-term
3000 - 3999	Capital
4000 - 4999	Income, Revenue or Sales
5000 - 5999	Job Costs
6000 - 6999	Overhead Costs
7000 - 7999	Other Income
8000 - 8999	Other Expenses

This is the numbering system for the Chart of Accounts used in *QuickBooks Pro*, so I recommend that you stick with this format. In addition, the CD provided with *Contractor's Guide to QuickBooks Pro* contains a Chart of Accounts already set up for *Your Company* that you can use as is, or easily modify. So, actually setting up the Chart of Accounts for your business will be very easy. A section entitled *Your Company* is shown in Figure 6-1.

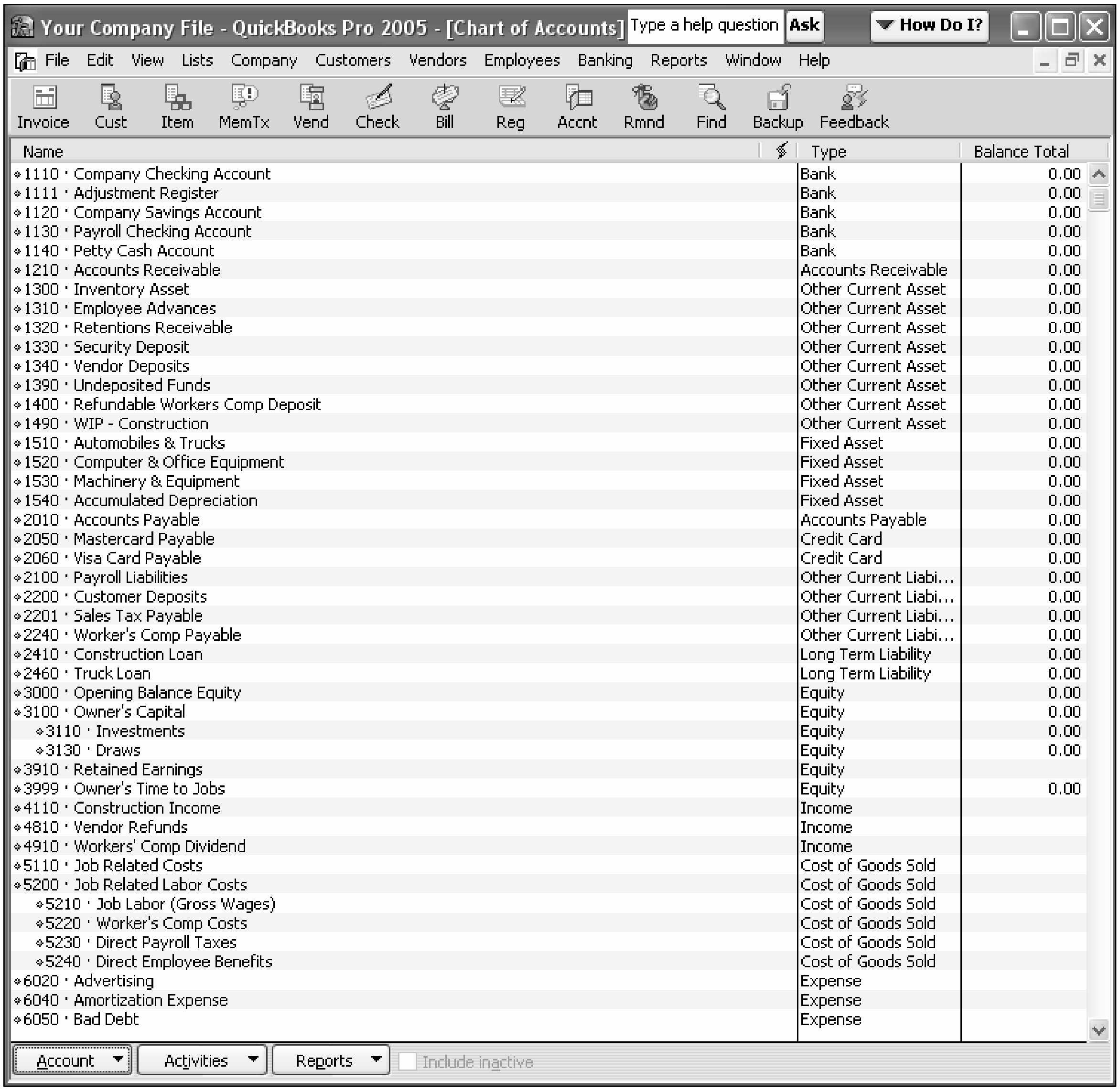
Let's look at these account types in a little more detail.



Assets

Assets include everything that the company owns, and is usually divided into two distinct groups, Current Assets and Fixed Assets. *The order in which accounts are listed is generally based upon how liquid the asset is, i.e. how easy it is to convert to cash.* So your checking account usually comes first, while something that has to be sold to generate cash comes towards the end of the assets accounts section.

Currents assets, 1000-1499, are items that are either already cash or things that can easily be converted to cash. So current assets include checking



Name	Type	Balance Total
1110 · Company Checking Account	Bank	0.00
1111 · Adjustment Register	Bank	0.00
1120 · Company Savings Account	Bank	0.00
1130 · Payroll Checking Account	Bank	0.00
1140 · Petty Cash Account	Bank	0.00
1210 · Accounts Receivable	Accounts Receivable	0.00
1300 · Inventory Asset	Other Current Asset	0.00
1310 · Employee Advances	Other Current Asset	0.00
1320 · Retentions Receivable	Other Current Asset	0.00
1330 · Security Deposit	Other Current Asset	0.00
1340 · Vendor Deposits	Other Current Asset	0.00
1390 · Undeposited Funds	Other Current Asset	0.00
1400 · Refundable Workers Comp Deposit	Other Current Asset	0.00
1490 · WIP - Construction	Other Current Asset	0.00
1510 · Automobiles & Trucks	Fixed Asset	0.00
1520 · Computer & Office Equipment	Fixed Asset	0.00
1530 · Machinery & Equipment	Fixed Asset	0.00
1540 · Accumulated Depreciation	Fixed Asset	0.00
2010 · Accounts Payable	Accounts Payable	0.00
2050 · Mastercard Payable	Credit Card	0.00
2060 · Visa Card Payable	Credit Card	0.00
2100 · Payroll Liabilities	Other Current Liabi...	0.00
2200 · Customer Deposits	Other Current Liabi...	0.00
2201 · Sales Tax Payable	Other Current Liabi...	0.00
2240 · Worker's Comp Payable	Other Current Liabi...	0.00
2410 · Construction Loan	Long Term Liability	0.00
2460 · Truck Loan	Long Term Liability	0.00
3000 · Opening Balance Equity	Equity	0.00
3100 · Owner's Capital	Equity	0.00
3110 · Investments	Equity	0.00
3130 · Draws	Equity	0.00
3910 · Retained Earnings	Equity	
3999 · Owner's Time to Jobs	Equity	0.00
4110 · Construction Income	Income	
4810 · Vendor Refunds	Income	
4910 · Workers' Comp Dividend	Income	
5110 · Job Related Costs	Cost of Goods Sold	
5200 · Job Related Labor Costs	Cost of Goods Sold	
5210 · Job Labor (Gross Wages)	Cost of Goods Sold	
5220 · Worker's Comp Costs	Cost of Goods Sold	
5230 · Direct Payroll Taxes	Cost of Goods Sold	
5240 · Direct Employee Benefits	Cost of Goods Sold	
6020 · Advertising	Expense	
6040 · Amortization Expense	Expense	
6050 · Bad Debt	Expense	

Chart of account for Your Company (only first section shown)
Figure 6-1

accounts, savings accounts, money market accounts, CDs, accounts receivable, inventory, loans that you've made to anyone, and any pre-payments that you've already made though you've not yet received the goods or services. Pre-payments are such things as insurance premiums, rent and deposits on utilities.

For easier updating, spread the account numbers out, rather than numbering consecutively, so if you want to add other account numbers, you can slot additional accounts in at a convenient spot.

Fixed assets, 1500-1999, are items of value the company owns that you'd have to sell in order to convert them to cash. Fixed assets include land, property, equipment, automobiles, office equipment, etc. Fixed assets are entered at the price you paid for them, and any depreciation/appreciation in their value is recorded in another account.

Liabilities

Liabilities, 2000-2999, are monies that your company owes (to lenders, to vendors, to employees, etc.). Liabilities are also divided into two parts, Current Liabilities and Long-Term Debt. Current liabilities are payments that need to be made within the next year, and include accounts payable (to vendors), credit card debt, employees' salaries, taxes and short-term loans. They should also include that part of any long-term debt which has to be paid in the next 12 months, even if the bulk of the payments may be outside that period. Any deposit a customer has made *prior to having the work done* (money that you haven't actually earned yet), falls under current liabilities as well. If the work never gets done, for some reason, that deposit would have to be refunded, so it's still a liability at this stage. Long-term debt is self-explanatory.

Capital

Capital entries use the 3000 series of account numbers. The way the capital account is structured depends upon whether your business is a sole proprietorship, a partnership or a corporation. Assuming that it's a sole proprietorship (you're the owner/operator), you'll need to set up a Capital Account and a Drawing Account. The Capital Account numbers are used to keep track of the money that you've invested in starting up the business and any additional money you've put into the business over the years plus or minus the profit or loss the company has made in the ensuing years (usually called Retained Earnings). The Drawing Account is where you draw your salary and any other monies intended for personal use.

These are the three main account categories that go into making up your Balance Sheet. The remaining Chart of Account categories are used in your Income or Profit and Loss (P&L) Statement. We'll come to them in a moment.

This is a good time to introduce you to the concept of the *Balance Sheet,* the more conventional way of presenting your Financial Statement.

Balance Sheet

A Balance Sheet uses exactly the same information as the Financial Statement but presents it in a slightly different way, so that the Assets and Liabilities sides of the equation are in balance, as the name suggests. Remember from Chapter 1, the Basic Equation of Accounting is:

ASSETS	–	LIABILITIES	=	NET WORTH
what you have		what you owe		value to owners

In a Balance Sheet, this is rearranged to:

Assets	=	Liabilities	+	Net Worth
what you have		what you owe		value to owners

Net Worth consists of the monies that you, the owner, your partners or your stockholders have put into the business, either at the outset or as time went along, plus your *Retained Earnings*. Retained earnings are the profits that the company has accumulated over the years and has retained on the books rather than distributing them to the owner, partners or shareholders. So look at this from the perspective of the company: the Assets are what the company has or has coming to it, the Liabilities are what the company owes, and the Net Worth is what the owner, partners and/or shareholders owe the company. The two sides should balance, hence the name *Balance Sheet*.

So what should a Balance Sheet look like? Figure 6-2 shows a typical format for a balance sheet. Depending upon which accounting text you consult, you'll find a number of minor variations in what's included under each bolded heading. The one constant is that the Total Current Assets line must equal the Total Liabilities and Net Worth/Owner's Equity line. This balance sheet is based on the format found in *Contractor's Guide to QuickBooks Pro.* To make up your own balance sheet you can copy this version from Figure A1-5 in Appendix 1 at the back of the book, or copy the Excel file found on the CD which accompanies *Contractor's Guide to QuickBooks Pro.*

I've used the same numbers that were in the Adjusted Financial Statement, Figure 2-8, to make up this Balance Sheet for the Twice Right Construction Company. You'll notice that the Total Assets line and the Total Liabilities and Net Worth/Owner's Equity lines are in balance at $1,103,360.

Cash Accounting versus Accrual Accounting

Before we go any further, let me take a moment to point out that there are two distinct ways of accounting: Cash Accounting and Accrual Accounting. The difference between these two is the time at which you make your entries, especially for income and expenses. Cash Accounting is just like keeping your check book. You make entries into your accounting system for checks you write or deposits you make at the time you actually write the check or deposit the money. It's strictly a cash-based approach and frankly not very helpful to you in running your business. That's because it doesn't help you anticipate future needs for cash or the ability to spend future earnings on new projects, which is what growing the business is all about.

By comparison, Accrual Accounting is based upon making the entries into your accounting system when your customer has agreed to pay you some money, or you have placed an order to spend some money. You don't actually wait to make the entry until the money has changed hands, as in

BALANCE SHEET

NAME: TWICE RIGHT CONSTRUCTION   DATE: 5/6/2007

CURRENT ASSETS		
CASH	$29,490	
ACCOUNTS RECEIVABLE	453,560	
INVENTORY	105,400	
PREPAID EXPENSES	0	
TOTAL CURRENT ASSETS		$588,450
FIXED ASSETS		
PROPERTY	$375,000	
EQUIPMENT	139,910	
TOTAL FIXED ASSETS		$514,910
TOTAL ASSETS		$1,103,360
LIABILITIES		
CURRENT - ACCOUNTS PAYABLE	$232,540	
SALARIES PAYABLE	15,500	
CREDIT CARDS	5,560	
TAXES	55,880	
LONG TERM NOTES PAYABLE	405,430	
TOTAL LIABILITIES		$714,910
NET WORTH/OWNER'S EQUITY		
OWNER'S INVESTMENT/COMMON STOCK		$100,000
RETAINED EARNINGS		288,450
TOTAL NET WORTH/OWNER'S EQUITY		$388,450
TOTAL LIABILITIES AND NET WORTH/OWNER'S EQUITY		$1,103,360

Balance sheet
Figure 6-2

a cash-based system. Rather, you make the entry when you feel confident that either someone owes you money or you owe money to someone.

So, if you do some work on a contract, and the payment terms are that you should be paid 30 days after completion, as soon as you've finished the work you send out an invoice and you make an entry in your Accounts Receivable (A/R) account. Likewise, if you order something on 30-day payment terms, that entry goes into Job Costs if it's for a specific job or into Overhead Costs if it's for the general expenses, at the same time as you place the order. In either case it's an Accounts Payable (A/P) entry.

Using Accounts Payable and Accounts Receivable allows you to track all the near-term financial commitments that have been made to you and that you've made to others. This gives you the insight you need to make wise decisions about the way you run the company in the near future. So I recommend that you use an accrual-based system of accounting, which is essentially assumed in *QuickBooks Pro* and *Contractor's Guide to QuickBooks Pro* (although they do give you the alternative option if you wish to use it).

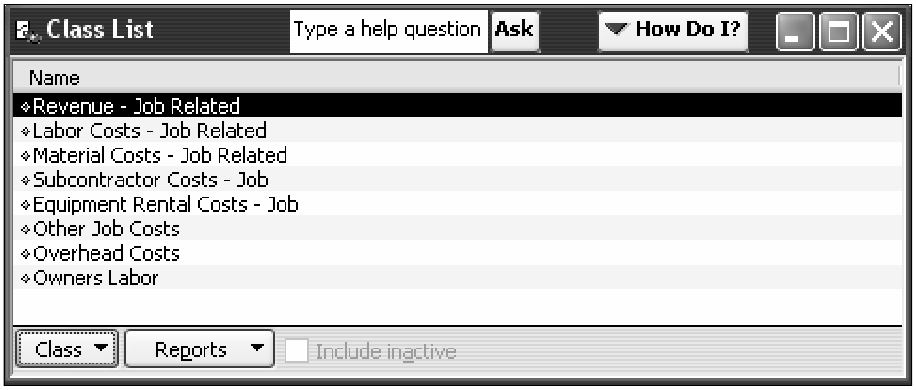
Setting Up a Chart of Accounts (Part 2)

Let's get back to the remaining categories in the Chart of Accounts, Figure 6-2. Then we'll look at another way of generating the Income Statement that we first created in Figure 2-9.

Income, Revenue or Sales

Income, *revenue* and *sales* are all one and the same in the accounting world, and not to be confused with *earnings*, which are the same as *profits*. As we all know, it's possible to have lots of income or revenue and still fail to make a profit or have any earnings, if your job costs and expenses are too high. So what is classified as *income* or *revenue* in the 4000 series of account numbers? This type of income is any money coming into the company from the construction jobs you're working on. And since you're using accrual accounting, you make the entry, not when the money actually comes as a check or even cash, but rather, when you've just sent out an invoice for the work and you're sure the money will be coming in.

Depending upon the contract and the scope of the work, the invoice might be for the complete job. On the other hand, if the contract is to build a complete house, scheduled to take approximately nine months, then your original contract should have included monthly progress payments. Each progress payment will probably be based upon the amount of labor used, the materials purchased and the subcontractor costs incurred during the previous month, but that isn't necessarily the case. Each progress payment will be whatever you agreed to with the customer in the original contract. You might try to *front-load* the progress payments, so that you can get ahead of the game, if the customer is agreeable.



Class list
Figure 6-3

At the end of each month you'll submit an invoice for that progress payment and make the entry as an account receivable for that particular job. This still leaves the balance of the payments in backlog. You'll invoice for these payments in the future when that part of the work is completed. For the moment you can't invoice for them, therefore you can't *recognize them as revenue*, as the saying goes.

> **"...it's possible to have lots of income or revenue and still fail to make a profit..."**

Other income, from such things as rent from property you own or interest on loans you've made to others should be recorded under *Other Income*, the 7000 series of account numbers. So the income we record in the 4000 series of account numbers is just from operations.

Job Costs

As the name implies, *Job Costs* are those costs directly involved in the construction job(s), and are typically given the 5000 series account numbers in your Chart of Accounts. If you're building a house, the job costs will include direct labor, materials used, subcontractors' costs, equipment rental, dump fees and other job-specific costs. If your company is also designing the house, then there will be job costs for design labor and engineering costs as well. The job files in Your Company are set up to have one total job cost for each job, but are broken down into classes for labor, materials, subcontractors, equipment rental and other costs related to the job, as in the *Class List* in Figure 6-3.

There are two very important reasons for keeping accurate job cost records. First, your job cost records should be the foundation for every future estimate you make. The best estimating costs you can use for your next job are the actual costs of your last job. Second, without accurate job cost records you don't know how much you've spent on the project to date, and therefore how much more you can spend and still make a profit.

The essential thing in job costing is to record all your costs when the money is committed, and to enter all expenditures in the correct categories. Job costing is a constant process. Do it daily. If you're the type of builder who lets his receipts pile up, it's now time to stop doing that. Get and keep your paperwork up to date. You'll never know where you stand financially if you don't stay on top of your paperwork.

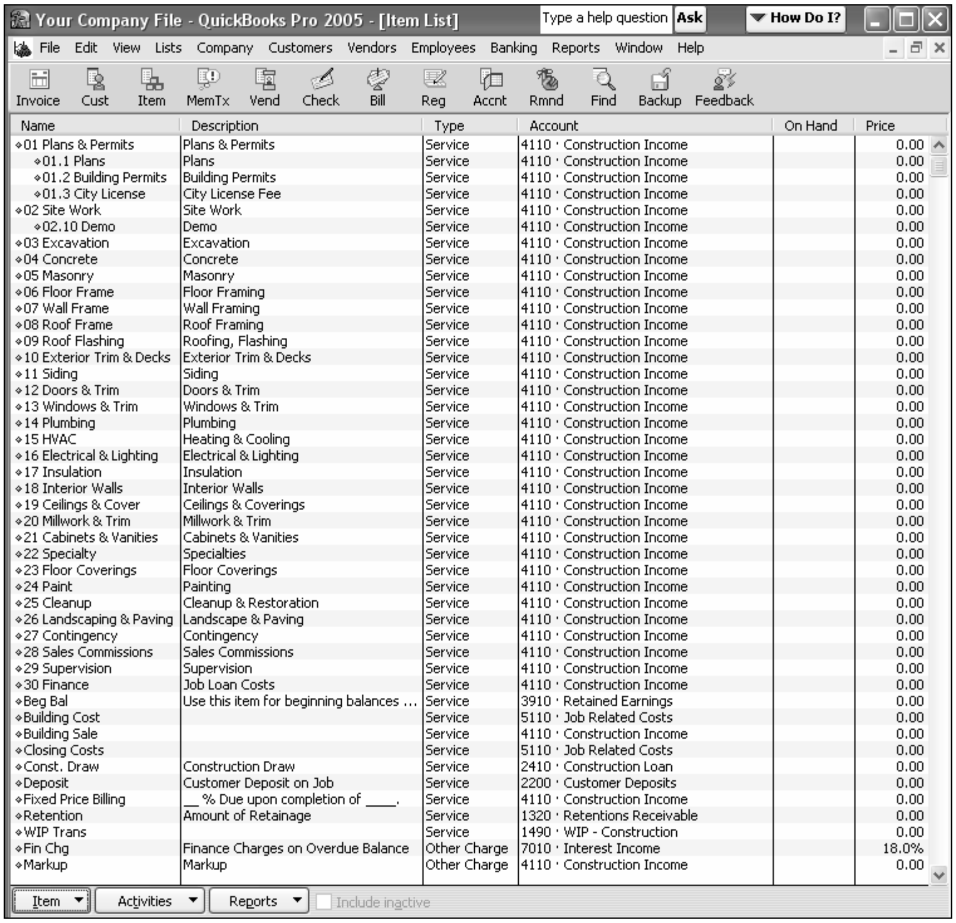
The job cost record tracks all expenditures by job name, date, order number, the amount of money committed and the correct category in the item list. Once the cost is recorded correctly, you can easily pull up a subtotal on any individual portion of the job without having to go through all of your individual records. *QuickBooks Pro* will give you a current cost for any job, for any period of time you select. Pull up a job cost subtotal one to three days before you plan to send out an invoice to make sure your costs are still on track. But, whatever the costs incurred are, make sure that the invoice you send out is in line with the progress payment schedule agreed to in the contract.

If you did a good job in setting up the initial contract, the progress payment should easily cover the job costs incurred for that period. If not, resolve to do a better job next time. And if things are really desperate, you may have to go "cap in hand," with a full listing of your job costs so far, and ask for another progress payment to be brought forward.

Overhead Costs

Overhead Costs are generally given the 6000 series account numbers in your Chart of Accounts. These are the fixed costs incurred in running your business, regardless of how many or how few jobs you're working on. Included in *Overhead Costs* are the payroll for the office staff, rent, telephone, insurance, utilities, postage, etc. (i.e. all the bills that you'll have to pay, that are not related to any specific job). Obviously, the amount your business can afford to spend on overhead costs will be related to how much business you're doing.

On the other hand, if you're doing very little business, you don't need and certainly can't afford to pay for a large office staff, with high overhead costs. However, as your business grows and there's more paperwork, bookkeeping, estimating and invoicing to be done, you'll have to increase your office staff, and your overhead costs will rise. *Overhead Costs* should be in the range of 10-20 percent of revenue and, clearly, the lower the better, as you have to add overhead to every estimate you do, as you'll see in Chapter 13. In the Twice Right Construction Income Statement, back in Chapter 2, Figure 2-9, overhead costs were $101,525 for the year, on revenue of $1,204,755. That's only about 8.5 percent, which is very low, meaning that they're running a very lean operation, appropriate for a company that's struggling to make ends meet.



Name	Description	Type	Account	On Hand	Price
◊01 Plans & Permits	Plans & Permits	Service	4110 · Construction Income		0.00
◊01.1 Plans	Plans	Service	4110 · Construction Income		0.00
◊01.2 Building Permits	Building Permits	Service	4110 · Construction Income		0.00
◊01.3 City License	City License Fee	Service	4110 · Construction Income		0.00
◊02 Site Work	Site Work	Service	4110 · Construction Income		0.00
◊02.10 Demo	Demo	Service	4110 · Construction Income		0.00
◊03 Excavation	Excavation	Service	4110 · Construction Income		0.00
◊04 Concrete	Concrete	Service	4110 · Construction Income		0.00
◊05 Masonry	Masonry	Service	4110 · Construction Income		0.00
◊06 Floor Frame	Floor Framing	Service	4110 · Construction Income		0.00
◊07 Wall Frame	Wall Framing	Service	4110 · Construction Income		0.00
◊08 Roof Frame	Roof Framing	Service	4110 · Construction Income		0.00
◊09 Roof Flashing	Roofing, Flashing	Service	4110 · Construction Income		0.00
◊10 Exterior Trim & Decks	Exterior Trim & Decks	Service	4110 · Construction Income		0.00
◊11 Siding	Siding	Service	4110 · Construction Income		0.00
◊12 Doors & Trim	Doors & Trim	Service	4110 · Construction Income		0.00
◊13 Windows & Trim	Windows & Trim	Service	4110 · Construction Income		0.00
◊14 Plumbing	Plumbing	Service	4110 · Construction Income		0.00
◊15 HVAC	Heating & Cooling	Service	4110 · Construction Income		0.00
◊16 Electrical & Lighting	Electrical & Lighting	Service	4110 · Construction Income		0.00
◊17 Insulation	Insulation	Service	4110 · Construction Income		0.00
◊18 Interior Walls	Interior Walls	Service	4110 · Construction Income		0.00
◊19 Ceilings & Cover	Ceilings & Coverings	Service	4110 · Construction Income		0.00
◊20 Millwork & Trim	Millwork & Trim	Service	4110 · Construction Income		0.00
◊21 Cabinets & Vanities	Cabinets & Vanities	Service	4110 · Construction Income		0.00
◊22 Specialty	Specialties	Service	4110 · Construction Income		0.00
◊23 Floor Coverings	Floor Coverings	Service	4110 · Construction Income		0.00
◊24 Paint	Painting	Service	4110 · Construction Income		0.00
◊25 Cleanup	Cleanup & Restoration	Service	4110 · Construction Income		0.00
◊26 Landscaping & Paving	Landscape & Paving	Service	4110 · Construction Income		0.00
◊27 Contingency	Contingency	Service	4110 · Construction Income		0.00
◊28 Sales Commissions	Sales Commissions	Service	4110 · Construction Income		0.00
◊29 Supervision	Supervision	Service	4110 · Construction Income		0.00
◊30 Finance	Job Loan Costs	Service	4110 · Construction Income		0.00
◊Beg Bal	Use this item for beginning balances ...	Service	3910 · Retained Earnings		0.00
◊Building Cost		Service	5110 · Job Related Costs		0.00
◊Building Sale		Service	4110 · Construction Income		0.00
◊Closing Costs		Service	5110 · Job Related Costs		0.00
◊Const. Draw	Construction Draw	Service	2410 · Construction Loan		0.00
◊Deposit	Customer Deposit on Job	Service	2200 · Customer Deposits		0.00
◊Fixed Price Billing	__ % Due upon completion of ____.	Service	4110 · Construction Income		0.00
◊Retention	Amount of Retainage	Service	1320 · Retentions Receivable		0.00
◊WIP Trans		Service	1490 · WIP - Construction		0.00
◊Fin Chg	Finance Charges on Overdue Balance	Other Charge	7010 · Interest Income		18.0%
◊Markup	Markup	Other Charge	4110 · Construction Income		0.00

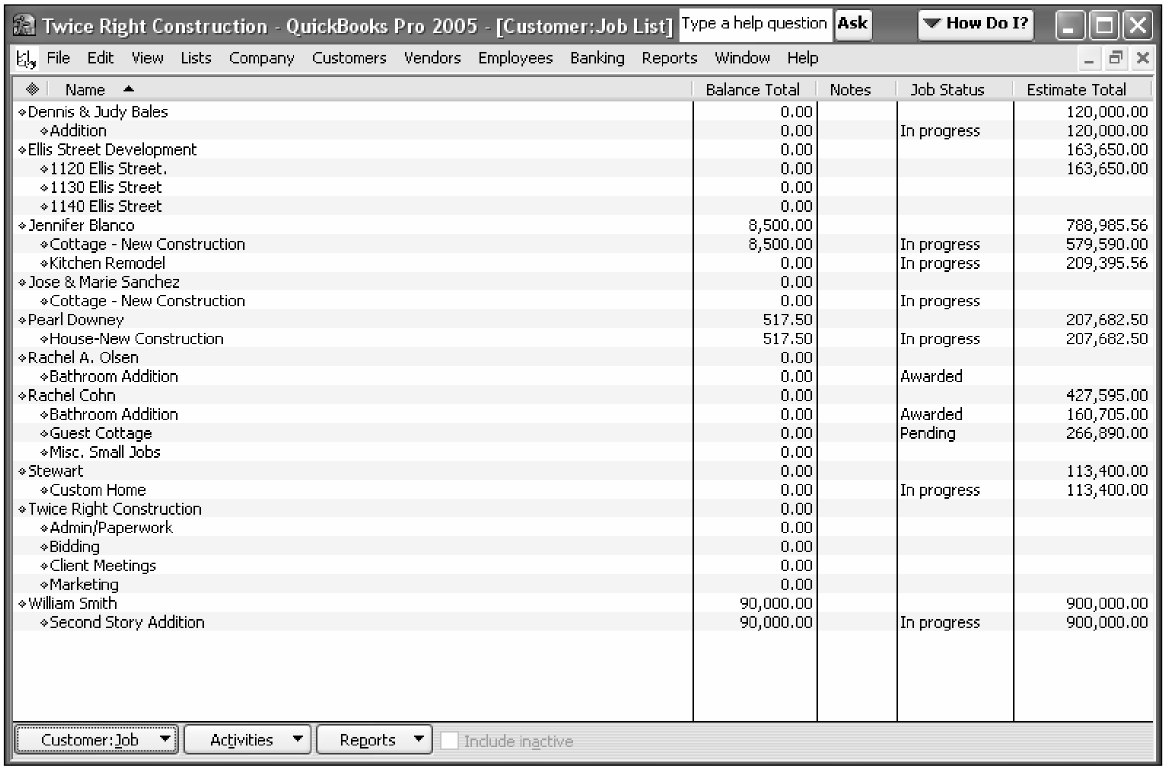
Your Company items list
Figure 6-4

Other Income

As mentioned earlier, *Other Income*, the 7000 series of numbers in your Chart of Accounts, is reserved for any income you receive outside of operations (i.e. construction jobs). These sources of additional income could be interest on loans you've made, gains on the sale of assets, insurance settlements or stock sales, for example.

Other Expenses

Likewise, *Other Expenses*, the 8000 series of numbers in your Chart of Accounts, is reserved for any costs which are not *Job Costs* or *Overhead Costs*, such as the loss on the sale of an asset or stockbroker's fees. Be careful not to use this category as a general dumping ground for those expenses when you prefer not to figure out the correct category. This will only distort your business account profile. Remember, the reports you get from your accounting system will only be as good as the data you enter. So be sure to make the effort to put the entries in the correct categories.



Name	Balance Total	Notes	Job Status	Estimate Total
◆Dennis & Judy Bales	0.00			120,000.00
◆Addition	0.00		In progress	120,000.00
◆Ellis Street Development	0.00			163,650.00
◆1120 Ellis Street.	0.00			163,650.00
◆1130 Ellis Street	0.00			
◆1140 Ellis Street	0.00			
◆Jennifer Blanco	8,500.00			788,985.56
◆Cottage - New Construction	8,500.00		In progress	579,590.00
◆Kitchen Remodel	0.00		In progress	209,395.56
◆Jose & Marie Sanchez	0.00			
◆Cottage - New Construction	0.00		In progress	
◆Pearl Downey	517.50			207,682.50
◆House-New Construction	517.50		In progress	207,682.50
◆Rachel A. Olsen	0.00			
◆Bathroom Addition	0.00		Awarded	
◆Rachel Cohn	0.00			427,595.00
◆Bathroom Addition	0.00		Awarded	160,705.00
◆Guest Cottage	0.00		Pending	266,890.00
◆Misc. Small Jobs	0.00			
◆Stewart	0.00			113,400.00
◆Custom Home	0.00		In progress	113,400.00
◆Twice Right Construction	0.00			
◆Admin/Paperwork	0.00			
◆Bidding	0.00			
◆Client Meetings	0.00			
◆Marketing	0.00			
◆William Smith	90,000.00			900,000.00
◆Second Story Addition	90,000.00		In progress	900,000.00

Customer job list
Figure 6-5

Lists

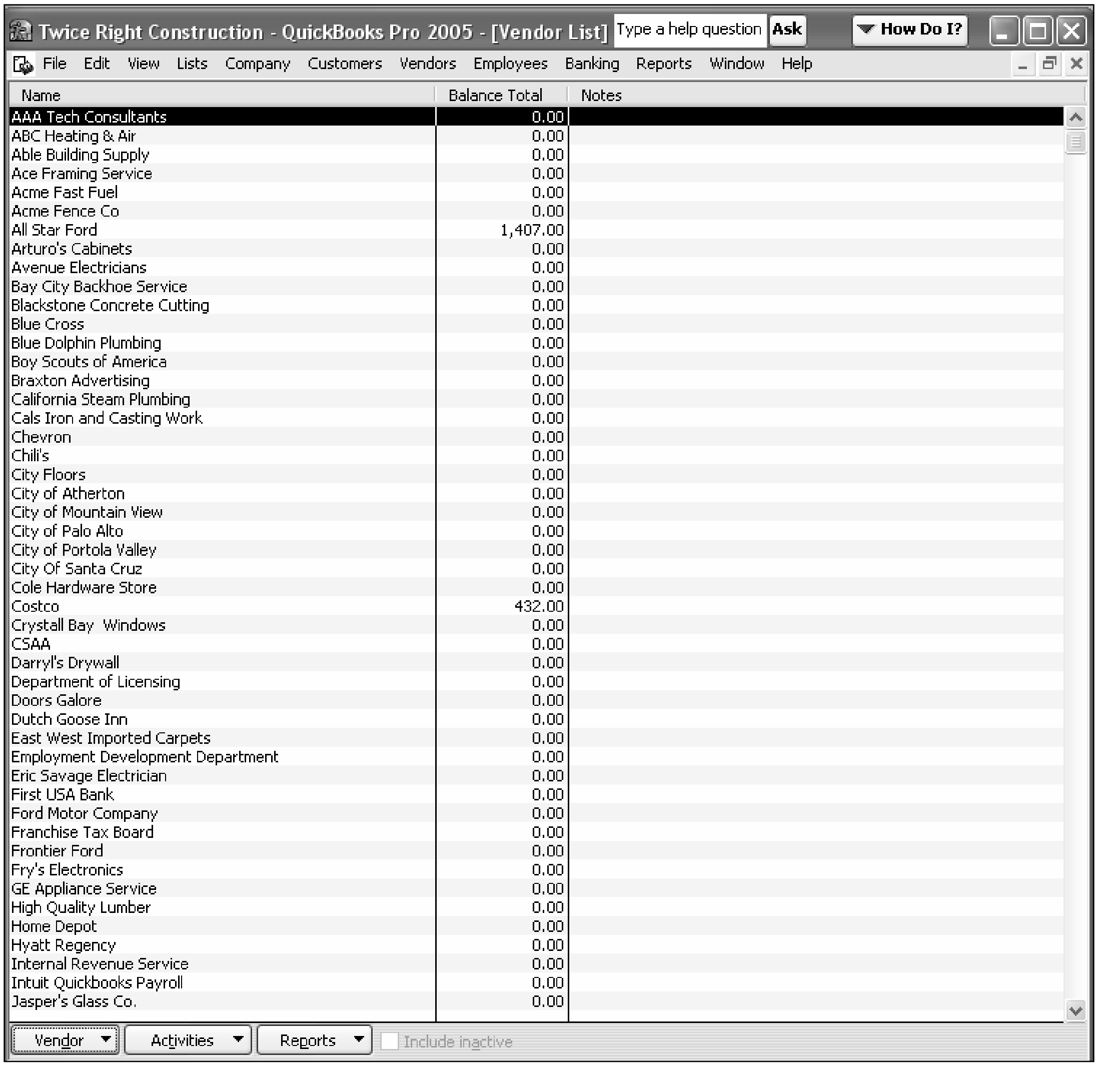
We've now covered all the categories in your Chart of Accounts, but you still need to set up an *Items List* (a list of the various jobs involved and materials used in a construction project) in Figure 6-4, a *Customer List* in Figure 6-5, a *Vendors/Suppliers List*, including Subcontractors, in Figure 6-6, and an *Employees List* in Figure 6-7. All of these are fairly self-explanatory and well-covered in *Contractor's Guide to QuickBooks Pro*.

Item List

An *Item List* is a list of all the jobs and materials necessary to complete a project. Having this list allows you to not only schedule the job efficiently and place timely orders, but also break down the costs and invoices into the various parts of the complete job, so that you can set up a series of progress payments. An example from the Your Company file in *Contractor's Guide to QuickBooks Pro* is shown in Figure 6-4. You can start with this sample list and modify it as you go along.

Customer List

Your *Customer List* is where you record the customer information on projects for which you've already received contracts (been awarded), the ones you're working on (in progress), and the contracts that you're still trying to



Name	Balance Total	Notes
AAA Tech Consultants	0.00	
ABC Heating & Air	0.00	
Able Building Supply	0.00	
Ace Framing Service	0.00	
Acme Fast Fuel	0.00	
Acme Fence Co	0.00	
All Star Ford	1,407.00	
Arturo's Cabinets	0.00	
Avenue Electricians	0.00	
Bay City Backhoe Service	0.00	
Blackstone Concrete Cutting	0.00	
Blue Cross	0.00	
Blue Dolphin Plumbing	0.00	
Boy Scouts of America	0.00	
Braxton Advertising	0.00	
California Steam Plumbing	0.00	
Cals Iron and Casting Work	0.00	
Chevron	0.00	
Chili's	0.00	
City Floors	0.00	
City of Atherton	0.00	
City of Mountain View	0.00	
City of Palo Alto	0.00	
City of Portola Valley	0.00	
City Of Santa Cruz	0.00	
Cole Hardware Store	0.00	
Costco	432.00	
Crystall Bay Windows	0.00	
CSAA	0.00	
Darryl's Drywall	0.00	
Department of Licensing	0.00	
Doors Galore	0.00	
Dutch Goose Inn	0.00	
East West Imported Carpets	0.00	
Employment Development Department	0.00	
Eric Savage Electrician	0.00	
First USA Bank	0.00	
Ford Motor Company	0.00	
Franchise Tax Board	0.00	
Frontier Ford	0.00	
Fry's Electronics	0.00	
GE Appliance Service	0.00	
High Quality Lumber	0.00	
Home Depot	0.00	
Hyatt Regency	0.00	
Internal Revenue Service	0.00	
Intuit Quickbooks Payroll	0.00	
Jasper's Glass Co.	0.00	

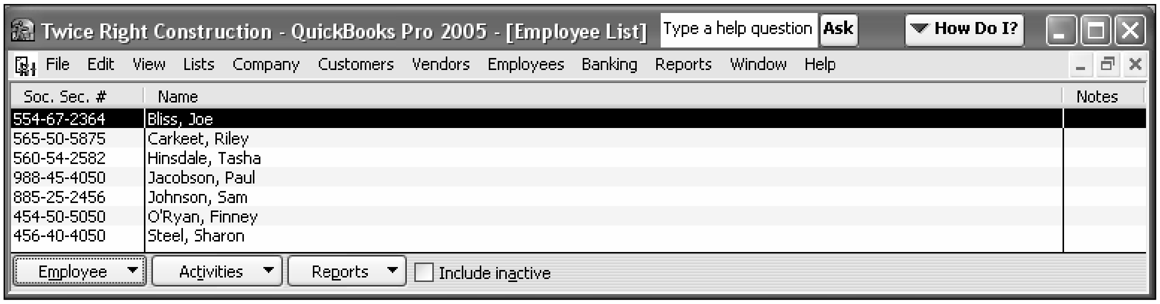
Vendor list (only first part shown)

Figure 6-6

get (pending). It also includes the estimate total and balance of the account still to be invoiced. A typical example is shown in Figure 6-5.

Vendors/Suppliers List

In *QuickBooks Pro*, there's no difference between a materials supplier and a subcontractor; they're both suppliers of either goods or services. It's important to follow the instructions in *Contractor's Guide to QuickBooks Pro* because you'll need to differentiate among vendors with whom you expect to do more than $600-worth of business in the tax year and those that you don't. That's because you're required to report to the IRS on Form 1099 the yearly total amount you paid each vendor that supplied you with



Employees list
Figure 6-7

more than $600-worth of business. Instructions for setting up 1099 and non-1099 vendors are beyond the scope of this book, but are spelled out in *Contractor's Guide to QuickBooks Pro*. An example of part of a *Vendors List* is shown in Figure 6-6.

Employees List

Finally, you'll need an *Employees List*. There are two reasons for having an employees list: first, if you're going to process your own payroll, and second, if you want to track employees' time by job, even if your payroll is processed by a payroll service. As you'll see in a moment, I highly recommend that you have your payroll processed by a payroll service if you're just starting out using *QuickBooks Pro*. You have enough other things to worry about. You'll want to track your employees' time by job, so set up an *Employees List* as in Figure 6-7. A blank form is available in Your Company file on the *Contractor's Guide to QuickBooks Pro* CD.

You're now ready to start making entries. How you go about this and the other details are well-covered in *Contractor's Guide to QuickBooks Pro*. So let's move on to the reporting side of accounting, which is where you can start making decisions that will improve the performance of your business.

Reports

QuickBooks Pro gives you a host of reports under a number of categories.

- Company and Financial, including the Balance Sheet and Income Statement
- Customer Status
- Accounts Receivable

- Accounts Payable
- Purchases
- Inventory
- Employees
- Payroll, etc.

We don't need to discuss all of these. You'll learn how to use them when you start using *QuickBooks Pro*.

Most of these reports are self-explanatory, but one report is particularly useful, and can be made even more useful by a little manipulation not covered in either *QuickBooks Pro* or *Contractor's Guide to QuickBooks Pro*. It's included in Appendix 2 at the back of this book.

Income versus Expense Graph

I said earlier that we'd take a moment to look at a somewhat more useful way of presenting the Income Statement information, back in Chapter 2, Figure 2-9. The standard *QuickBooks Pro* reports take the Income Statement information, Figure 6-8, and present it as a monthly, quarterly or yearly Income vs. Expenses report in the form of a bar chart, Figure 6-9.

Figure 6-9 shows the report on a monthly basis. Unfortunately, this doesn't give the most useful graphical presentation of the data, in my opinion. I've selected a period of time, Sept '08 thru Aug '09 when the fortunes of the Twice Right Company improved considerably. Looking at the Income Statement (Figure 6-8) the company now seems to be making a substantial profit, $312,419 — but there's a problem.

We don't learn much from a basic annual Income Statement, so let's see how the company did on a month-by-month basis, and present the data as a bar chart (all of the reports in *QuickBooks Pro* are shown as bar charts).

"...trends become much more obvious when the data are presented as a graph..."

You'll notice that the Income bar (shown grey) is generally higher than the Expense bar (shown hatched), just as we need it to be for the company to be profitable. However, it isn't always higher. In January '09, income just about equals expenses so the company only just manages to break even. In the last two months of the year income is actually less than expenses. So even though the company was substantially profitable for the full year, it's now starting to lose money.

Twice Right Construction - QuickBooks Pro 2005 - [Profit & Loss] Type a help question Ask How Do I?

File Edit View Lists Company Customers Vendors Employees Banking Reports Window Help

Modify Report... Memorize... Print... E-mail Export... Hide Header Collapse Refresh

Dates Custom From 09/01/2008 To 08/31/2009 Columns Total only Sort By Default

Twice Right Construction

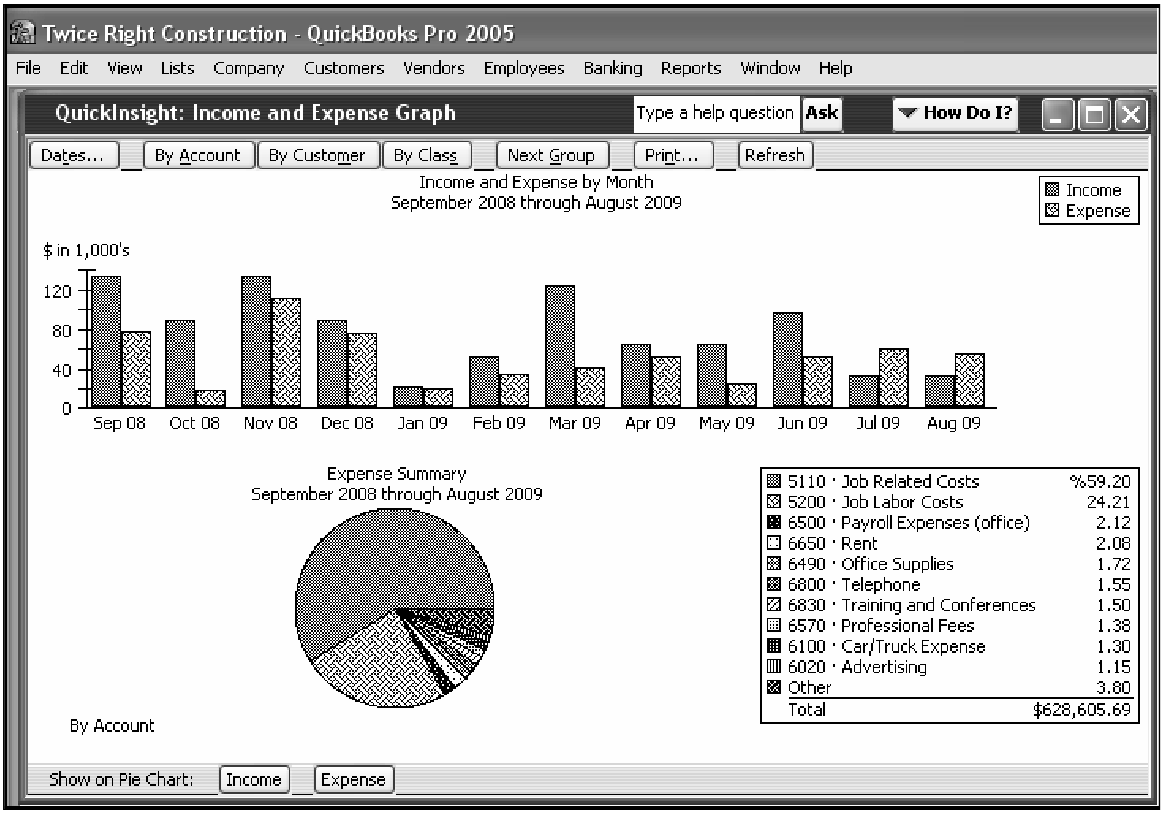
Profit & Loss

Accrual Basis — **September 2008 through August 2009**

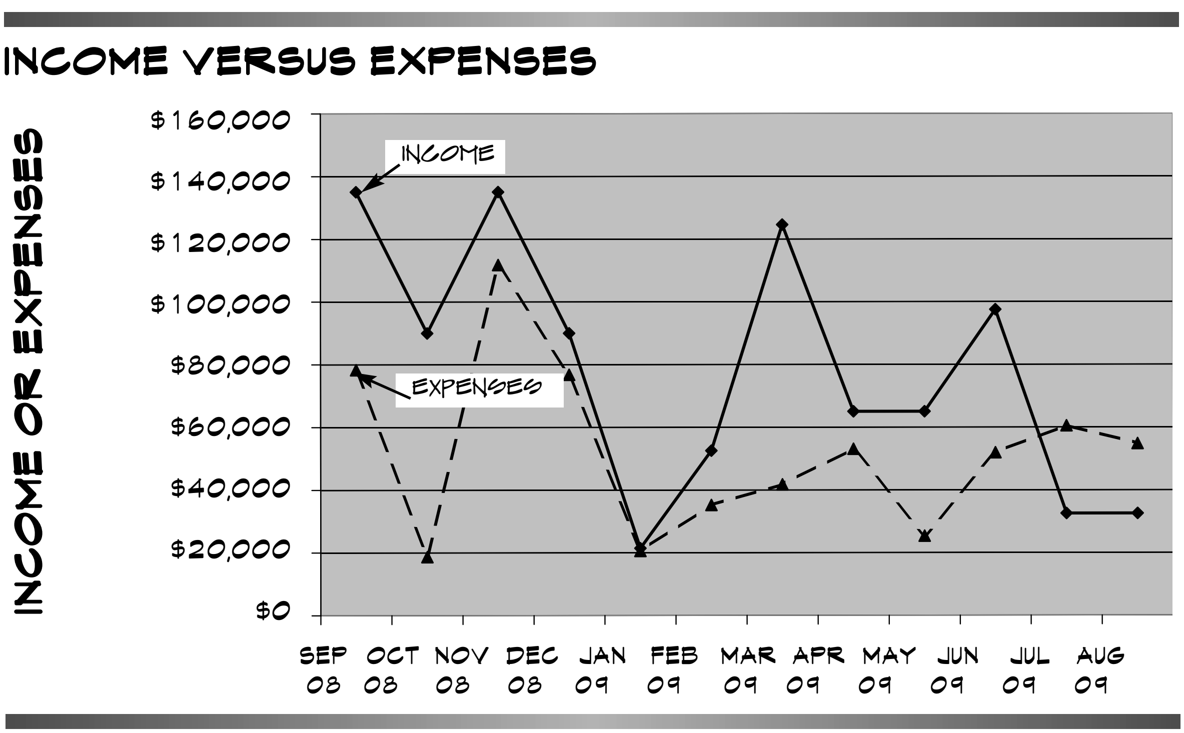
		Sep '08 - Aug 09
Ordinary Income/Expense		
Income		
4110 · Construction Income		940,955.00
Total Income		940,955.00
Cost of Goods Sold		
5110 · Job Related Costs		372,120.76
5200 · Job Labor Costs		
5210 · Job Labor (Gross Wages)	132,719.75	
5220 · Worker's Compensation Costs	12,849.99	
5230 · Direct Payroll Taxes	6,587.16	
Total 5200 · Job Labor Costs		152,156.90
Total COGS		524,277.66
Gross Profit		416,677.34
Expense		
6020 · Advertising		7,250.00
6050 · Bad Debt		2,500.00
6060 · Bank Service Charges		142.00
6090 · Business License & Fees		105.00
6100 · Car/Truck Expense		
6101 · Gas & Oil	2,569.45	
6103 · Repairs & Maintenance	3,544.22	
6107 · Insurance-Auto	2,050.00	
Total 6100 · Car/Truck Expense		8,163.67
6135 · Computer Supplies/Equipment		212.02
6140 · Contributions		1,200.00
6160 · Dues and Subscriptions		2,500.00
6180 · Insurance		
6182 · Liability Insurance	2,230.00	
6185 · Worker's Comp	102.27	
Total 6180 · Insurance		2,332.27
6200 · Interest Expense		
6202 · Loan Interest	2,725.00	
Total 6200 · Interest Expense		2,725.00
6490 · Office Supplies		10,533.58
6500 · Payroll Expenses (office)		
6501 · Payroll (office staff)	7,200.00	
6504 · Designer's Wages	4,162.50	
6510 · Employee Benefits	1,972.00	
Total 6500 · Payroll Expenses (office)		13,334.50
6570 · Professional Fees		
6571 · Accounting	4,050.00	
6572 · Legal Fees	1,402.00	
6573 · Computer Consultants	3,250.00	
Total 6570 · Professional Fees		8,702.00
6610 · Postage and Delivery		810.00
6650 · Rent		13,060.00
6800 · Telephone		9,724.78
6820 · Taxes		1,589.00
6830 · Training and Conferences		9,400.00
6900 · Travel & Ent		
6901 · Entertainment	2,355.80	
6902 · Meals	373.10	
Total 6900 · Travel & Ent		2,728.90
6920 · Tools & Machinery (under $500)		5,512.81
6970 · Utilities		1,503.50
Total Expense		104,328.03
Net Ordinary Income		312,349.31
Net Income		**312,349.31**

Income statement

Figure 6-8



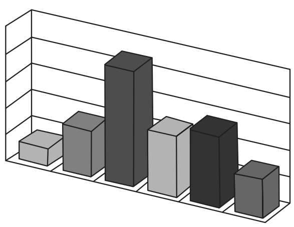
Income versus expense bar chart
Figure 6-9



Income versus expense graph
Figure 6-10

However, the trends become much more obvious when the data are presented as a graph, with one line for income and one for expenses. In this way, the points where the two lines meet or cross-over become much more evident. This capability is not part of *QuickBooks Pro*, but the way to set it up is shown in Appendix 2. The result for this set of data is shown in Figure 6-10.

I think you'll agree that the trends in the performance of the Twice Right Company's business are much clearer in this graph, and show that the company went through a bad spell in the winter of '08/'09. This isn't unusual for a construction company, as winter weather can slow progress on outdoor projects in many parts of the country. Performance recovered as the spring building season started up, only to plunge again at the height of the summer building season. Clearly, management needs to take some corrective action.



You really need to know at this stage what the projected company performance will be for the next few months, so you can judge what type of corrective action is necessary. If future operations look strong and there are a number of good progress payments coming in future months, perhaps no major corrective action is necessary. If, on the other hand, orders for new business have been slow and progress payments for future months are few and far between, you'll need to be much more aggressive in going after new business, and/or drastically reducing expenses to bring the company back to profitability.

Having established the database for the Income versus Expense Graph, Figure 6-10, in Appendix 2, you'll find it's very easy to add in the progress payments for future months, for the contracts you're working on, plus the job and overhead costs for these projects. These job and overhead costs can be taken directly from your job estimates. You can now project the Income versus Expenses graph out into the future. This will enable you to make the correct decisions for the company's performance. *This is the real strength of a good, accrual-based, accounting system.*

We've now had a quick look at some important aspects of a modern computer-based accounting system, and I hope that you've been encouraged to get yourself a copy of the *QuickBooks Pro* program (available online at www. Quickbooks.com or from any office products store), and a copy of *Contractor's Guide to QuickBooks Pro*, to help guide you through the program set-up for your own construction company. However, as with home exercise equipment, it's not just buying the products that's important, but using them on a constant basis. So set aside a couple of weekends to set up the software and enter your current data. Then you'll be set to go.

People Aspects of the Accounting System

Now that we've spent some time on the impersonal aspects of running the numbers side of your accounting system, we need to spend some time on the more personal aspects, because, as you well know, business success is about people just as much as it is about numbers.

DAILY TIME SLIP

WORK DONE BY ______________________ PAYROLL NO. ______________

JOB NAME ______________________ DATE ______________

WORK DESCRIPTION	COMMENT	START TIME	END TIME	TOTAL TIME	CODE NO.	ADJUST	ADJUST TOTAL
			TOTALS				

Daily time slip
Figure 6-11

Payroll

A contractor's largest single expense is almost certainly his payroll. Contractors hate paydays. They're always coming at the wrong times — like the beginning, middle, or end of the month, when there's no money left. As an employee, you can't wait for payday. As an employer, you want to put it off as long as possible.

Time Cards

First, let's take a look at time-keeping methods. Most companies use simple time cards that can be bought at a stationery store. Alternatively, you can make copies of the Daily Time Slip from Figure A1-6 in Appendix 1 or from the Forms file on the CD supplied with *Contractor's Guide to QuickBooks Pro*, shown in Figure 6-11.

The time card records the elapsed time each employee worked each day. You can also use it to record the job number and the type of work done during that time. You should have a separate time slip for each employee and a specific number for each aspect of the job, from your Items List. The employee should write in, opposite the time worked, a short description of the work done. This can be used later to figure job costs and to compare estimated costs versus actual costs. These data can then be used to adjust future estimates.

Generally, you use one card per employee per week. The employee should write in his start and end times using military time — hundred minute hours and 24-hour days (i.e. 13.25 rather than 1:15 pm). You may feel it's adequate to record job time to a minimum of a quarter of an hour, as that makes it fairly easy to convert to hundred minute hours since a quarter of an hour is 15 minutes, and a quarter of a 100-minute hour is 0.25. If you want to be more accurate than 15 minutes you'll need to give each employee a copy of the Minutes-to-Hundredths-of-an-Hour Conversion Table shown in Appendix 3.

Using decimal minutes makes adding each employee's work time and the total work time on the project much easier, since computers can only add decimals and not normal hours and minutes. So someone has to convert the hours worked to decimals. This may be too much to ask of a basic laborer, in which case, you'll have to do it yourself or have your pay clerk do it.

Payroll Service

Once you've got the hours worked by each employee, I recommend that you have a payroll service figure the amount due each worker. An outside service will figure out all the withholdings, and prepare checks for your signature or do direct deposits into your employees' accounts. They will also write a check against your payroll account. The cost of these services for a company with five employees, being paid twice a month, can be as little as $30 per month and as little as $100 per month for 50 employees.

A good payroll service will do all of the following for you:

- Take your employee hours inputs each period
- Calculate amounts due each employee — we'll cover withholdings in a moment
- Provide next day delivery of checks for your signature, or

- Do direct deposits into your employees' accounts
- Make payroll tax deposits via the Electronic Federal Tax Payment System
- Make automatic payment and filing of quarterly payroll tax returns
- Do the record keeping of tax withholdings, FICA, Medicare, SDI, FUTA, UI, ETT, etc.
- Give you a payroll summary, check journal and general ledger summary with each payroll
- Provide an employee master report with each payroll
- Do record keeping for any 401K plans
- Handle health plan withholdings and records
- Report any new hires to the state
- Handle workers' compensation record keeping and payments
- Handle vacation and sick leave record keeping
- Prepare year-end tax returns and W-2s

This should save you a small fortune in manhours and frustration. Many independent services and banks, as well as *QuickBooks* itself (see the Process your Payroll link at the quickbooks.intuit.com website), offer a payroll service. For a listing of major payroll services you can check out the www.BuyerZone.com website.

If you're only using subcontractors, you have no payroll concerns to worry about. But be careful! Having a contract with each tradesman or paying in cash doesn't make the recipient any less of an employee. The IRS and your state figure that if you set the working hours, supervise the work, and use workers who don't have their own business license or carry their own insurance, they're your employees. *That lets the IRS hit you, even some years later, for all the withholding taxes you didn't deduct!*

EMPLOYER PAYMENTS AND EMPLOYEE WITHHOLDINGS (CALIFORNIA)

	EMPLOYER	EMPLOYEE
FEDERAL		
FEDERAL INCOME TAX		DEPENDS ON SALARY AND DEPENDENTS CLAIMED
SOCIAL SECURITY (FICA)	6.2%*	6.2%*
MEDICARE (MED)	1.45%	1.45%
UNEMPLOYMENT TAX (FUTA)	0.80%	N/A
STATE		
STATE INCOME TAX		DEPENDS ON SALARY AND STATE
DISABILITY INSURANCE (SDI)		0.90%
UNEMPLOYMENT INSURANCE (UI)	3.40%	N/A
EMPLOYMENT TRAINING	0.10%	N/A
OPTIONAL		
SHARE OF HEALTH PREMIUM	?	?
401K PAYMENTS	?	?

* UP TO A MAXIMUM SALARY OF $90,000, BUT EXPECTED TO RISE IN FOLLOWING YEARS, MAYBE SUBSTANTIALLY.

Employer payments and employee withholdings (California)
Figure 6-12

Withholdings

If you have employees, you should know all about withholdings so you'll know where the money is going even if you're using a payroll service. Payroll withholding is detailed and exacting work. *Failing to withhold, or to forward the amounts withheld to the tax authorities, can put you in hot water in a hurry.* As an employer, you're always at fault when there's a mistake. That's just one more reason to use an outside service, until you're ready to try to do it yourself using *QuickBooks Pro*. But I suspect you'll find that there's always something more useful you can do with your time. And with payroll services being relatively inexpensive, you'll probably stick with one once you've gotten started. Anyway, let's just take a moment to see what's involved in calculating withholding for each employee. Figure 6-12 shows what you, the employer, have to pay for each employee, and what you have to withhold from each employee's check every payment period.

If you do the math, you'll see that the total payments and withholdings for both you, the employer, and for the employee amount to over 20 percent of the employee's salary each payment period. That's a substantial chunk of money and one of the things you have to factor in every time you think of taking on another employee. Fortunately, the employee is paying 8.55 percent of this, so you're only left with about 12 percent to pay. But this is still significant on top of the employee's salary. Other costs to consider can be the company's contributions to a health insurance plan and to a 401K retirement plan that you may decide to offer. And we still have to get to Workers' Compensation Insurance, which can be another big chunk of money per employee.

Not all states have the same withholding requirements. Your state will have a tax booklet that explains how to figure withholding for your employees, if you want to get into the details. Note that these rates vary both from state to state and from time to time.

The tax money withheld from employees' checks stays in your bank account until the deposit date required by law. Deposit dates vary by state and at the whim of elected and appointed officials. Until then, the money is yours to use. But don't come up short on deposit day! It's your responsibility to make sure there are sufficient funds in the bank account to cover the deposit that the payroll service makes for you.

FICA deposits made for you have to be accompanied by a deposit card issued by the IRS. The card is printed with your Federal Employer ID number, which you get from your local IRS field office.

And it isn't just the Feds that want their cut; the state wants its cut too. Most states have three basic deductions, state income tax, state disability and state unemployment compensation. State income tax is based on the amount earned, and varies with the number of dependents declared. State disability is also based on income, but any income over a certain amount each year is usually exempt. Unemployment compensation is based on gross company payroll, but companies with lower unemployment claims (a better employee retention rate) usually pay a lower rate. If you hire and fire frequently, expect to pay a higher unemployment compensation rate.

You've now probably decided that all this withholding stuff is far too complex for you to waste your time on. So until you're much more familiar with *QuickBooks Pro*, I recommend that you use a payroll service. All you have to do, a day or two before paychecks are to be issued, is phone, fax or e-mail in the hours each employee worked. The service takes care of the rest for you.

Insurance

As a building contractor, it's as easy to be insurance-poor as it is to be land-poor. However, everything doesn't need to be insured. Accept some reasonable risks yourself and save the premiums you would otherwise spend. There's a limit to what any contractor can afford to cover.

Workers' Compensation Insurance

However, you must carry Workers' Compensation Insurance to cover all employees, even clerical workers. But only direct employees need to be covered, not subcontractors. The cost varies, based on your payroll and the kind of work each employee performs. It also varies from state to state. In some states, such as California, the courts tend to award much larger injury settlements; consequently Workers' Comp coverage premiums are significantly higher. This has led some companies to move to states with lower premiums. The cost per $100 of payroll is very high for some construction trades. For roofers and steel erectors, Workers' Comp can cost as much as $20 for each $100 of payroll. The cost for carpenters is about half that. Clerical work is much safer so it carries a rate of about 50¢ per $100 of payroll.

Your insurance carrier has the right to audit your books quarterly to verify payroll and check the classification of all employees. Falsify a report and your insurance could be cancelled. But, there *are* ways to save money. The classification system used by insurance carriers is fairly basic. There's room for legitimate disagreement on what category a particular trade or job type falls into. Your auditor may claim that each arguable type of job falls into the higher-rated category. And he'll insist that division of each employee's time into several different classes is impossible or illegal. You can play that game too. Arrange the responsibilities of each employee on your work crews to maximize the number of low-rated jobs and minimize the number of high-rated jobs. That's perfectly legitimate!

"Your insurance carrier has the right to audit your books quarterly to verify payroll and check the classification of all employees."

Here's an example. Truck drivers, supervisors and laborers carry lower Workers' Comp rates than carpenters and roofers. If you have a four-man crew framing a house, one might be a full-time supervisor and another might be a laborer. Classifying the members of the crew as two carpenters, a supervisor and a laborer will cost you about $10 a day less for Workers' Comp than classifying all four of them as carpenters.

Distribute work so that some workers perform high-rated tasks and others handle only low-rated tasks. Having all workers do both low- and high-rated work puts all workers in the higher-rated Workers' Comp category.

Find out which jobs carry the lowest rates and arrange your crews so that some workers do only this kind of work. *The insurance-rating bureau in each state publishes a book that describes the type of work each category of worker is assumed to handle.* Your insurance agent will have a copy of this book and will quote you the current rate for each work category. Assign work accordingly.

If you have disability insurance, use it only to supplement your Workers' Compensation Insurance. *Coverage shouldn't exceed 75 percent of your monthly salary.* The premium will be very small if there's a six or nine month waiting period before payment begins under the policy.

Liability Insurance

You'll need Liability Insurance in addition to Workers' Comp coverage. Every builder needs property coverage and public liability insurance. These are usually bundled in a policy entitled *Comprehensive General Liability,* and include coverage for vehicles, equipment, a fidelity bond, and umbrella liability coverage. The cost will usually be about $3.00 for every $100 of payroll. Any general insurance agent can supply you with the details.

When shopping for insurance, contact two or three insurance agents who specialize in construction insurance. Tell them a little about your business, its volume and risks, and let them make coverage and cost proposals to you.

Once you've received their proposals, go through them carefully to decide which coverage you can do without. Then buy insurance to cover the rest. Here's a tip that could save a few hundred dollars a year. *Your subcontractors should have their own coverage.* It's much cheaper to require them to buy their own insurance than for you to cover them with yours. Provide in your contract with them that they must carry their own auto and truck liability coverage.

Don't insure everyone and everything on the job. Insure just yourself and your people, equipment, and materials. Let others on the job cover their own risks. In short, define your insurance risk and cover it. Then spread the remaining risk among those who should bear the responsibility.

Other Liabilities

Just having adequate insurance isn't enough. There are many ways to suffer a loss in the construction business. Insurance will cover many of these situations. But obviously, you're better off avoiding losses whenever possible, as they can cause serious interruptions in progress, costing time and money. And it's surprising how little effort is needed to prevent some major losses.

You can get hit with a loss any time, from before the first nail is driven to years after the project is complete. Not every loss can be anticipated, much less prevented. But in today's litigation-oriented society, it pays to be on your guard. Let's review a few of the situations that have high loss potential.

Commitments by Your Own People

Employees promising more than they or you can deliver — often without your knowledge — will get you in trouble every time. This is especially true if an employee has put a promise in writing. Prevent this situation by strictly counseling employees not to make any promise without your consent.

Any number of things an employee does or says could be interpreted as a commitment by the company. They'll get asked various questions by a customer and will be expected to give some sort of answer. So make sure they always say that they'll have to check it out with their supervisor in order to confirm it. And admonish them never to put anything in writing. If a written commitment is needed, tell them that you'll take care of it.

Working Conditions on the Job

Excess debris on the site gives the impression of poor supervision and invites a lawsuit if someone is injured. It also makes an injury more likely. Your tradesmen will fall over poorly-placed materials if the materials don't end up falling on your tradesmen. Provide your employees with, and insist that everyone wears, the necessary protective equipment, such as hard hats, back-support belts, and eye and ear protectors (when required). Also ensure that all safety equipment is installed on tools such as rotary saws. You should also have a policy that everyone on-site must wear boots with steel-reinforced toes, including yourself, though you don't necessarily have to provide them for your employees.

Poor control of access to the job site invites lawsuits. If a spectator or even a trespasser is injured, you'll waste precious time in court and with attorneys. Post a sign telling potential trespassers to stay away. Make an occasional visit to the site between 5:00 pm and 10:00 pm (when most unauthorized access occurs), and ask adjoining property owners to call you if they see anyone on the site after hours. Ask your tradesmen to inform you if they notice signs of unauthorized persons having been on the site overnight.

Shoddy Workmanship

You know what poor workmanship looks like. Poor work that goes uncorrected will eventually come back to haunt you. Don't ignore leaky roofs or windows, ductwork that won't stay together, concrete that cracks, and so on. Need I say more? Poor workmanship is a bad deal for almost everybody. Only lawyers make money out of it. It's best to prevent it from happening in the first place. Correcting poor workmanship costs more money, which can only come out of one place. And where's that? Your profits, of course. So do your best to hire staff who just don't make mistakes, or at least make mistakes rarely.

What about people in your organization who produce shoddy work? I'm not sure this can be cured. My advice is talk to them as soon as you see any evidence of poor workmanship. If that doesn't do the trick, get rid of them as soon as possible.

Other Financial Interactions

One of the most important financial interactions, perhaps even more important than the original sales process, is the invoicing process, as this is when the customer is finally parting with his hard-earned cash. If the customer is happy with your work and the way he's being billed and collections are being made, he'll be a satisfied customer. This will lead to new business, either by him giving you future projects or through referrals. But even if your employees have done the most magnificent piece of work for the customer, by screwing up the invoices and collections process, you can destroy a customer relationship.

Billing or Invoicing

Billing, or *invoicing* as it's generally known, must be done religiously as it's virtually your only source of income. The preparation of invoices, and reminders of invoice dates, will be done for you by *QuickBooks Pro*. Invoicing and collections run on a 30-day cycle in the construction business. Anything invoiced or paid sooner than that is done for your accommodation only. The only exception to this unwritten rule might be small, impoverished contractors who can't afford to carry payroll on jobs that start and end in less than a month.

But don't let the 30-day rule scare you. Few people start a construction company with that much financial cushion. In practice, you go from job to job trying to get far enough ahead of the game to comply with the normal billing cycle. Most contractors finally make it, but some never do.

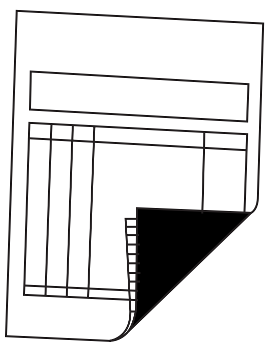
"Disagreements about invoices are the cause for most delays in receiving payment and for disputes..."

All invoices have to conform to the terms in the original contract. We haven't talked about contracts yet, but we will later in the book. For now, let's just assume that you've got a contract, you've done part of the work and a progress payment is due. Now it's approaching the end of the month and time to get your invoice sent out. Before having *QuickBooks Pro* prepare the invoice, read the terms of the contract again. It should spell out the date and the amount you can invoice and also the date you're going to get paid.

Many construction contracts require that you submit an invoice on or before the 25th of each month, with payment due on the 10th of the following month. Other invoices may be due for payment 30 days from issuance of the invoice.

Invoices for work in progress usually have a cutoff date. This will probably be the last Friday before the 25th. If you've been making your entries in *QuickBooks Pro* religiously, all of the materials costs, labor hours and overhead costs will automatically be available to the software to produce an accurate cost and invoice for you. Accuracy is the key. The invoice should spell out what the bill is for, which progress payment this is, according to the contract, and answer any questions you think the customer might have as to why he's receiving this invoice. Disagreements about invoices are the cause for most delays in receiving payment and for disputes that eventually lead to ill-feeling between you and your customer. Finally, make sure your invoices are correct — don't just accept the invoice that *QuickBooks Pro* churns out.

Statements



Statements are different from invoices. Use a monthly statement to summarize all unpaid invoices as of the statement date. Each statement should identify unpaid invoices by number and date. *QuickBooks Pro* will give you an Aging Accounts Receivable report, showing all overdue invoices, and produce a statement for you on request. This is a reminder to the client — your bill is past due!

Make your statements as clear as possible. They should show the exact status of each account — the original contract amount, any net change in the contract due to extras and credits, the total amount that's been paid to this date and the balance left owing after all payments have been deducted.

You may have clients who delay payment because, they claim, your invoices are confusing. Some will return an invoice without payment but with a request for an explanation. Worse yet, they may just let the invoices and statement sit in a file for a month or two until you call. As I mentioned above, make your invoices and statements clear, complete and as concise as possible. Then there is no excuse for the customer not to pay, and if he isn't paying the invoice, it's clear that it's a deliberate action on his part.

Perhaps he's in financial difficulty and can't pay the invoice. You need to know that as soon as possible so you can stop work on the project and avoid throwing good money after bad. Alternatively, he may just be a slow payer and a telephone call will get him to write a check. And don't accept that old "I'll put the check in the mail right now" — ask him when the check will be ready and say you'll stop by to pick it up.

Some clients lose invoices or seem to have a mailman who just "can't manage to deliver certain kinds of mail." Then you've got to issue another copy of the invoice. This time it's best to hand deliver it. Explain the invoice to the client while you're at his home or office. Ask for a check before you leave. Don't leave any room for quibbling or excuses. And don't leave without a check, or at least without a written course of action that you have to undertake, after which he will write a check. If this doesn't work, we move into the collections arena.

Collections

Everybody hates collections, both the collector and the collectee. Collecting overdue accounts is rarely painless. Nobody wants to part with money if he can avoid it, and particularly if it's in short supply.

But getting paid is up to you. Collecting is part of invoicing. Don't assume you're going to get paid just because you sent out a bill. Think of invoices as being like judgments in lawsuits. It's up to the creditor to collect, even after the judge says that payment is due. Nobody's going to collect for you. You've got to do it yourself.

The key to good collections is a combination of three factors. First, you can only collect from your client if he has the money available. Therefore, the collections process has to begin even before you sign a contract. How? You investigate. Where's the money for the project going to come from? Does your client have a reasonable amount set aside for any contingencies? Is your client financially sound? Does he have a history of paying his bills on time? This is generally referred to as a credit check. So, just as the bank will run a credit check on you before they'll give you a loan, you must run a credit check on your client before you sign a contract with him.

Second, collections are much easier if you do your job conscientiously and according to the contract. If you're never on time, if your workmanship is marginal or poor, or your employees rub customers the wrong way, you can expect collections to be an Olympic event.

"Don't assume you're going to get paid just because you sent out a bill."

Finally, your invoices must be in good order, on time, and have all necessary back-up materials enclosed, according to what was in the original contract. Otherwise, you'll confuse your client or his accounting department and you'll only get requests for more information or explanation rather than checks.

There's one more element that can help you when it comes to collections. It's known as perseverance. Stay in touch with the people you invoice. Know where your payments stand. Know what's owed you and where your invoice is in your client's accounting system.

Two weeks after bills go out, start calling clients who haven't paid. Keep constant pressure on delinquent accounts. Apply the pressure and you'll be at or near the top of every payment list. If your client needs a lien release or additional information, get it to him that afternoon. Don't let two or three days go by before you respond.

When an invoice has gone unpaid, or only partially paid, for more than 30 days, add interest at the maximum rate allowed under the contract and by your state. *You don't necessarily expect to collect this interest but it raises the settlement value of your claim as each month passes, if it eventually ends up in court, and gets the client's attention.*

Some bills may get paid sooner if you offer a 1 percent or 2 percent discount for payment within 10 days. But remember that a 1 percent discount for payment in 10 days rather than 30 days is *about the same as paying 20 percent annual interest on that money*. That's an expensive way to do business if it isn't necessary. If you have a tough time collecting from a client, repetitive calling may be the most effective collection technique. You'll either get paid or you'll find the reason why you're not getting paid and can perhaps do something about it. At the very least, you'll have his attention.

Finally, if you anticipate that collection is going to be a serious problem, don't work a single day past the payment date specified in the contract. Don't compound the problem by doing more work when you haven't been paid for the work you've already done. If your client is going to stall a creditor, let it be someone else, not you. Pull your crew off the job and get your lien papers in order. Let the client know just what to expect. He may never use you again, but at least you'll get paid for the work you've already done.

Here's why a threat to walk off a job is usually effective. Many owners have construction loans with draws against the loan every 30 days. But the bank can delay the next draw if there isn't sufficient progress at the job site. Threaten to hold a crew off the job and you'll get paid promptly, nine times out of 10.

Most clients pay on time. But others would rather sell their grandmother than pay when payment is due, even if they have the money sitting in the bank. Every client is unique — but you won't run into too many really bad apples, especially if you've done a good job on your up-front credit checking. But even one bad apple is enough to drive a contractor crazy.

Your other main people interactions on the accounting side of the business, after your employees and your customers, will be with your suppliers. You'll need to keep them happy, since they hold another of the important keys to you staying in business — getting the most favorable prices and payment terms.

Suppliers and Purchasing

If your finances are in good shape, opening charge accounts with suppliers should be a snap. However, most suppliers will require a financial statement and several credit references from you before they'll make the first substantial credit transaction. Almost anyone can get a credit card with a credit limit of $5,000 from one of the big box stores, but you'll need a line of credit much greater than that.

If your finances are in a shambles, however, getting credit is a different story. It's tough to work without credit, though it can be done. Most suppliers will put you on a C.O.D. basis. Fortunately, there are always a few suppliers who'll extend credit to almost anybody, once. Suppliers who are new in the business, or who need your account, will be more anxious to extend credit without a credit check.

Electrical and plumbing subcontractors have a tougher time getting credit without a careful credit check. Here's why. There are fewer specialty electrical and plumbing supply houses than there are lumberyards. Each distributor knows nearly all the creditworthy plumbing and electrical contractors in the local area. If you're not one of them, they'll be reluctant to do any credit-based business with you.

If you can't establish credit with your suppliers, you have two choices. First, you can get a draw from the customer against the contract price before the work starts, and keep the progress payment schedule ahead of your expenses. Some owners will do this, either out of ignorance, as a favor to you, or perhaps in return for a small discount or for something you throw in at no charge. If that's not possible, ask your customer to pay for materials as they're needed. Let the owner know before the work starts that you can't finance the material purchases out-of-pocket. He will have to pay for materials as they're purchased.

Even if you have a good payment record, purchasing is never a routine or easy task. *The easiest place to lose your profits is through lost or stolen materials.* It's every contractor's responsibility to see that what's paid for actually gets used on the job.

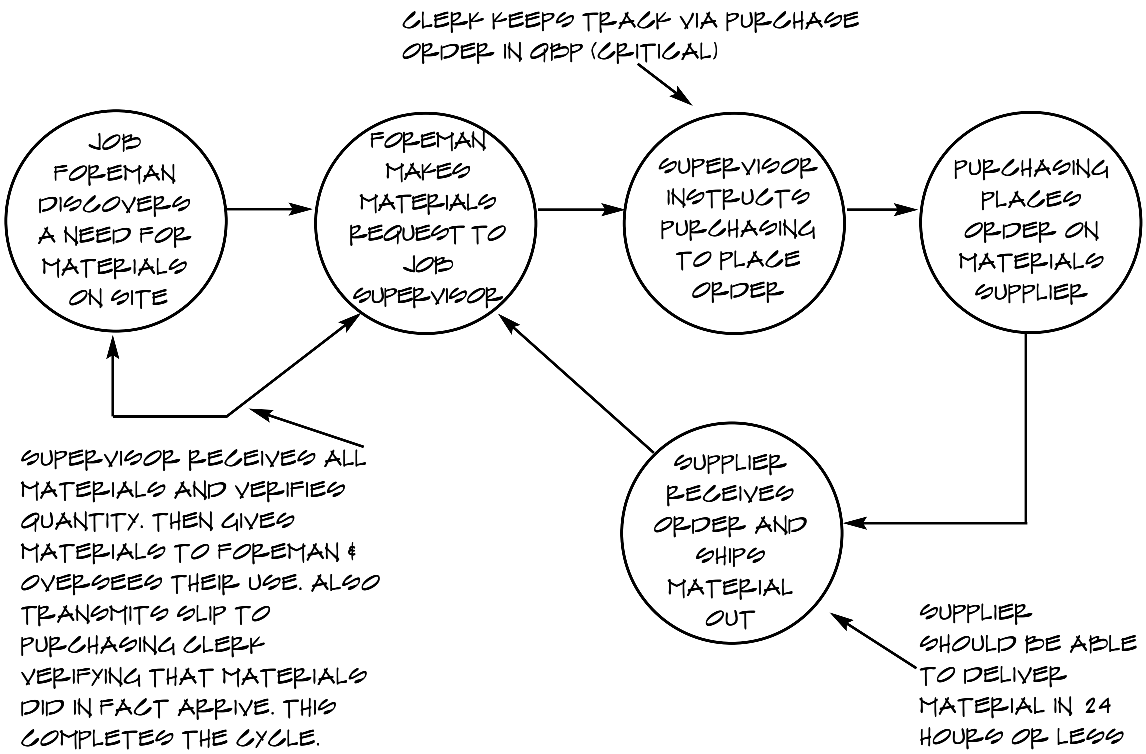
There are hundreds of ways to lose materials. You've got to limit *shrinkage* if you want to survive in construction. The most expensive stud on any job will be the one you have to buy to replace the one a carpenter took home with him for his own use.

How do you know that what was delivered is really what's needed for your job? Did you do the original take-off for the job? So why are you short of studs or joists? Who checked to see that what was ordered was actually delivered?

"Do you want to make money or are you just playing at contracting?"

I know these are hard questions. But let me ask you another. Do you want to make money or are you just playing at contracting? If you can't keep track of your materials and your profits, you're running a charity, not a business.

PURCHASING PROCESS

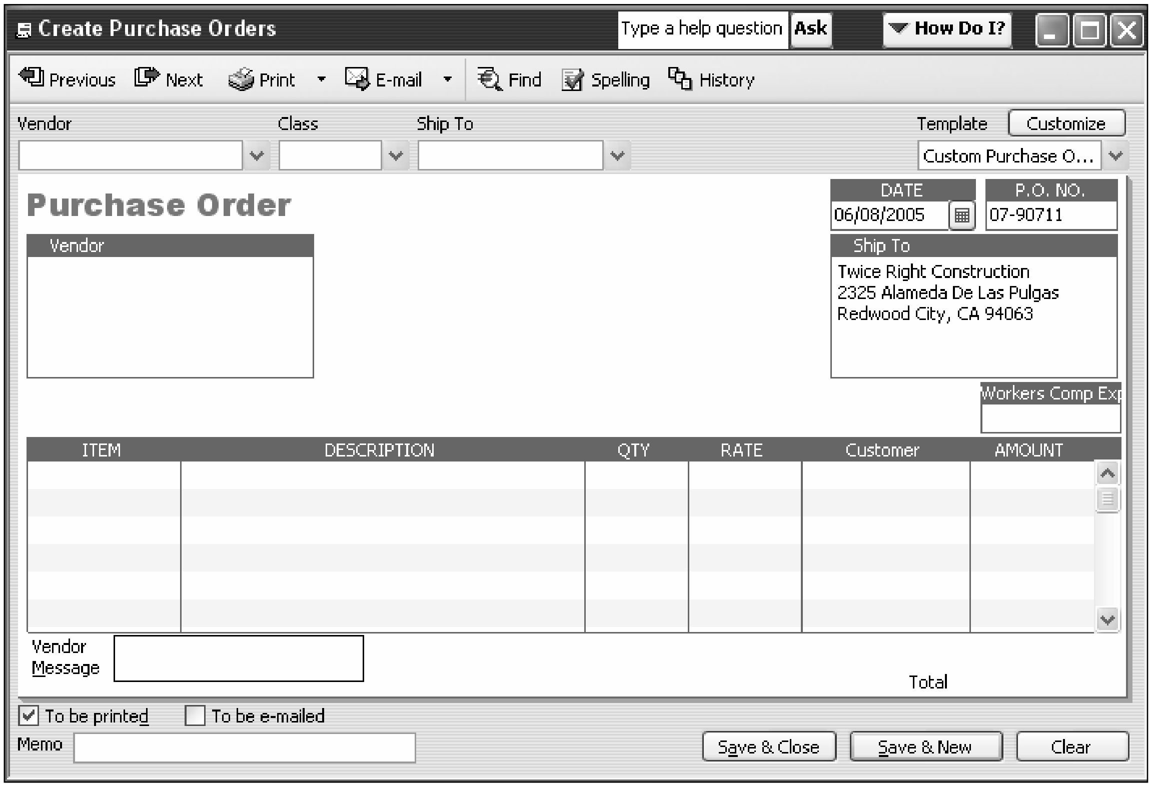


Purchasing process
Figure 6-13

I know a general contractor whose supervisor was ordering lumber, hardware, trusses, and other materials to build a mountain cabin. The only problem was that the project he was actually being paid to work on was a five-hundred house subdivision in suburban San Jose, not a cabin in the woods. The contractor didn't discover that he was also paying for a mountain cabin until he went out to the job site and reviewed the material lists personally. By that time, fifty thousand dollars worth of materials had been diverted off the job site.

Control of purchasing should be as routine and simple as possible. Figure 6-13 details a basic purchasing process. If your company is small enough, handle purchasing yourself. If not, confine it to two people — the supervisor and the purchasing clerk.

Most of the materials for a job will be ordered by you or your office staff based upon the estimate you generated for the job, and should be scheduled to be delivered, as required, to the jobsite. You can use the purchase order in *QuickBooks Pro* to place orders and automatically enter the correct costs into your accounts payable records. By clicking on the appropriate down



Purchase order
Figure 6-14

arrow, you can select the vendor's information from your Vendor List, the class it should be entered into from your Class List, the ship-to address from your Customer List and the items you need to order from your Item List. This saves you a great deal of time writing out or typing orders, and reduces errors.

A blank order form, with the Twice Right Construction Company address, the date and the next purchase order number already entered, is shown in Figure 6-14.

The one number you must enter manually is the quantity of the item you need, and this is where you refer to your estimate. If the item is fairly standard, which you know you'll use again if you order too many, it's advisable to order a few extra. They'll always get used on another job and it's better to have a few extra on hand than to have to waste time waiting for more material.

However, you have to balance the cost of time wasted in waiting for additional material against the chances that any extra material left over on a job will be pilfered by your employees. *Spare material has a terrible tendency to sprout legs*. How much extra material you're prepared to have on site depends upon the trust you have in your staff.

However carefully you pre-order the materials for the job, you'll find there are some items you need to order on-site. You discover you haven't enough of a particular item or a material isn't of adequate quality to be used, or something's just plain missing. Here are the steps to get new material to the job site. First, a tradesman, crew leader, or foreman discovers the need for an item. The foreman makes a request to the supervisor. The supervisor instructs the purchasing clerk (or secretary) to order the materials required. The purchasing clerk places the order. This must be done with a properly completed purchase order (as above) or it'll be lost from your accounting system and your accounts payable, making your job costs incorrect.

If the supplier's dispatcher is on the ball, you'll get delivery in no more than 24 hours. If you need same-day service, send one of your staff or have a courier pick up the item. The supervisor receives and signs for the materials requested. He compares what was ordered with what was actually received and informs the purchasing clerk of the materials that arrive each day.

This procedure may seem cumbersome, but it's not nearly as expensive as re-ordering lost or misplaced materials. With a little practice, nearly every step in the purchasing cycle — except actual delivery — can be done by phone followed up by an e-mail or fax so that there's an actual paper trail.

Embezzlements and Forgeries

This is an unpleasant topic, but I'm not going to shy away from it. Some employees will pick you clean if they can get away with it. I'm not just talking about occasional workers or subcontractors you hardly know. I'm talking about trusted regulars who've been on your payroll for years. And it's not just the odd roll of masking tape I'm talking about. I mean serious financial irregularities.

This is the voice of experience speaking. I know about embezzlements and forgeries. I was a victim to the tune of $15,000. An employee in my office gave me a real education in the finer points of checkbook gymnastics. I didn't even know you could do some of the things this person did with my checkbook. It was an expensive lesson and one that you have to avoid. This was before the days of computer-based accounting. But don't think there aren't just as many ways of fiddling computer-based books. I'm sure there are and perhaps even more difficult to spot.

Sign your own checks and reconcile your own checkbook in QuickBooks Pro. No matter how profitable you are, you're giving away the combination number to the safe if you let anyone else reconcile the accounts and review the cancelled checks.

Even if your bookkeeper doesn't sign checks, embezzlement is still possible. I'm the only one who signs on my company checking account. And I was still taken to the cleaners.

The best protection against forgery is to keep your check book under lock and key, and to review all cancelled checks returned by the bank. Beware if check numbers are missing from the sequence. The forger may be hoping that the missing check will go unnoticed for several months. Then if nothing is said about it, the forger will use it. It's very much like the house cleaner, who first moves a valuable object to a different spot in the house, then hides it. If you still don't miss it, the cleaner simply steals it.

If you are a check forgery victim, present your claim to the bank. They're responsible for preventing the clearing of forged checks. You can sue them for restitution.

Consider buying a fidelity bond on your bookkeeper. The cost is modest and any insurance agent can provide coverage. You might think of passing the cost of the bond on to your bookkeeper as a condition of employment, though this doesn't get you off to a very trusting start. But, people have to earn your trust, so you might set up a one-year trial, after which you'll refund the cost of the bond and pick up the cost in the future, if all goes well. Some states provide fidelity bonds to anyone who is not eligible for commercial bonding, at no cost to the employer or the employee. It's a useful tool for the state to help a job applicant get and keep a job, and remove them from the unemployment roles. Check with your local government to see if they offer such a program.

"Embezzlement is easy for someone who knows the system and who works without direct and constant supervision."

The easiest way to spot a forgery is to review your signature on all cancelled checks. Most people find it easy to recognize a forgery of their own signature. A signature forged by an amateur may have a faint pencil outline under the actual inked signature. That's a clear tip-off that there's been foul play.

Avoid signing checks with a broad felt-tip pen. That obscures many of the small characteristics that make your signature distinctive. A ball point pen emphasizes the pressure points in your signature. That's an important characteristic and it's difficult for a forger to copy. Here's another hint. Sign your name clearly. The sloppier your signature, the easier it is to copy.

Match your check records with the checks themselves to see that they're the same. Then tally the checks against the monthly bank statement. Count the number of cancelled checks and the number of the check debits on the statement and make sure they match. Finally, ask your accountant (or someone other than your secretary or bookkeeper) to go over the books at least once each quarter.

Embezzlement is easy for someone who knows the system and who works without direct and constant supervision. Let me give you some examples.

Have you ever asked your secretary to pick up $50 at the bank for the petty cash fund? You ask her to write a check for $50. She brings you a dated check made out for $50. You sign it and ask her to go to the bank while she's out doing some shopping on her lunch break, cash it and bring back the $50. Does that sound familiar?

Here's what might happen. Unknown to you, she adds a One in front of the Fifty, writes $50 on the check stub, then goes to the bank to cash the check. She puts $100 in her purse and the remaining $50 into the petty cash fund.

When the bank statement comes in, she destroys the altered check. You're happy — the check stub looks correct and the incriminating check is gone forever. She enters a $50 notation in the petty cash account in *QuickBooks Pro*. Unless you (or your accountant) reconcile the bank statement carefully, that $100 becomes just an unexplained error that's written off at the end of the year. No one will ever find the $100. Pretty slick, heh? Could it happen in your business? Of course it could.

Here's another scenario. A regular supplier calls to report that some materials are ready for pickup. Your secretary takes the call and notes the amount due as $654.29. But she makes out the check for $754.29 and you sign it. You send your secretary to pick up the goods. She comes back with three things, the material, an illegible or altered receipt, and $100 cash in her purse. You've used this supplier many times and trust him. The cost is always reasonable so you don't bother to check the invoice. The result — your secretary gets an extra $100 in tax-free cash.

Summary

Good accounting is essential to the success of any construction business. Get yourself a professional accounting software package and take the time to learn to set it up and use it accurately. *Contractor's Guide to QuickBooks Pro* has already done much of the work for you, so it's a good place to start. Set up your Chart of Accounts, Items List, Customers List, Vendors List and Employees List. You've only got to do it once, and it'll save you retyping and error correction in the future.

Learn about Balance Sheets, Income Statements and all of the many other reports that you can get from *QuickBooks Pro* to help you run your business. Generate an Income versus Expenses graph and keep it up to date. Project it forward for a few months depending on how much future business you have, so you can see what changes, if any, you need to keep your business profitable.

Realize that accounting isn't all about numbers — people are a very important part of your accounting system. You'll need a good time card system. At least initially it's better to hire a payroll service and e-mail, fax or phone in your employees' hours to them. They'll take care of the payroll checks and withholding deposits for you. That's one less thing you have to worry about.

Find yourself a good insurance agent with experience in Workers' Compensation insurance, and be sure to assign workers' tasks to get the best rates. Don't have everyone classed as a roofer or you'll go broke trying to pay the insurance premiums.

Make sure you train your staff to look after your interests and have them avoid making commitments you can't keep. Don't assume your workers come fully trained. Spend some time teaching them, and give them the working conditions to do a safe and efficient job. And remember, training is a continuous activity, not just a once in a lifetime event — take every opportunity you have to pass on tips and encouragement to your staff. *Communication and recognition of a job well done are just as important as salary to most people.*

"...accounting isn't all about numbers..."

Invoicing is the very heart of your business. Without it, no money ever comes into the business, and as soon as your initial investment is spent you're on the rocks. Do your invoicing diligently and check your accounts receivable report frequently. If invoices are overdue, don't be afraid to issue a reminder statement, and tackle your collection problems professionally. No one likes having to drag money out of customers, but unless you're prepared to do it you'd be better off going to work for someone else and avoiding the hassle altogether.

Finally, *only a fool assumes that every employee is honest.* If your accounting staff is inventive and careful enough, they can burn you four or five times a month in all sorts of ways. This is embezzlement, no matter how little is taken. Theft is theft. Control your own purchasing. Sign your own checks and sign your name clearly. Finally, have your accountant — not your secretary or bookkeeper — go over your accounts every quarter as a matter of routine.

Who, Me Work?

"What I want to do is buy a business, then kick back and let the employees do the work while I rake in the money." Have you ever heard anyone make a remark like that? If so, I hope you realize they're crazy. Anyone who thinks that way has never actually run a company. When you have employees, you can't relax, at least not for very long. Employees are just being paid to do a job, and generally have no particular interest in how well or how poorly the overall project turns out. Hopefully you've hired good employees who'll have pride in their work. But they may not be too concerned about how well it fits in with the whole project.

An employee is typically a specific tradesman, such as a plumber or a carpenter. While he may be very good at his own specialty, he may not be too attentive to how his work affects the tradesman who must follow him, such as the tile installer. Employees can make very expensive mistakes, often just through poor communication. They can undo the work that another employee has already done, eat up profits by taking their time to finish their particular jobs and spend time doing things that aren't needed at that particular time.

No matter how good your employees are, you can't just sit back and hope that everything will turn out OK. Unless you stay on top of it, it won't. And it's far easier to anticipate and avoid problems than to try to fix them after they've occurred, when the money has already been spent. Every entrepreneur has to be his own hardest-working employee if the business is to succeed.

When your business is small, and you've only got two or three employees or subcontractors, you're on-site a good deal of the time, so it's fairly easy to communicate with each of them and watch what they're doing on a daily basis. However, as your business grows, you'll be spending more time looking for and negotiating new contracts, dealing with your accountant, working with your architect and so on. You'll be able to spend much less time on-site and you'll need supervision of your on-site employees.

One way to do this is to take on a partner who can pick up some of the load of on-site supervision. Or you can hire a foreman to supervise your employees, or appoint one of your better employees to be a part-time foreman as well as working at his own trade. Let's first of all look at the option of taking on a partner.

Sole Proprietor or Partnership

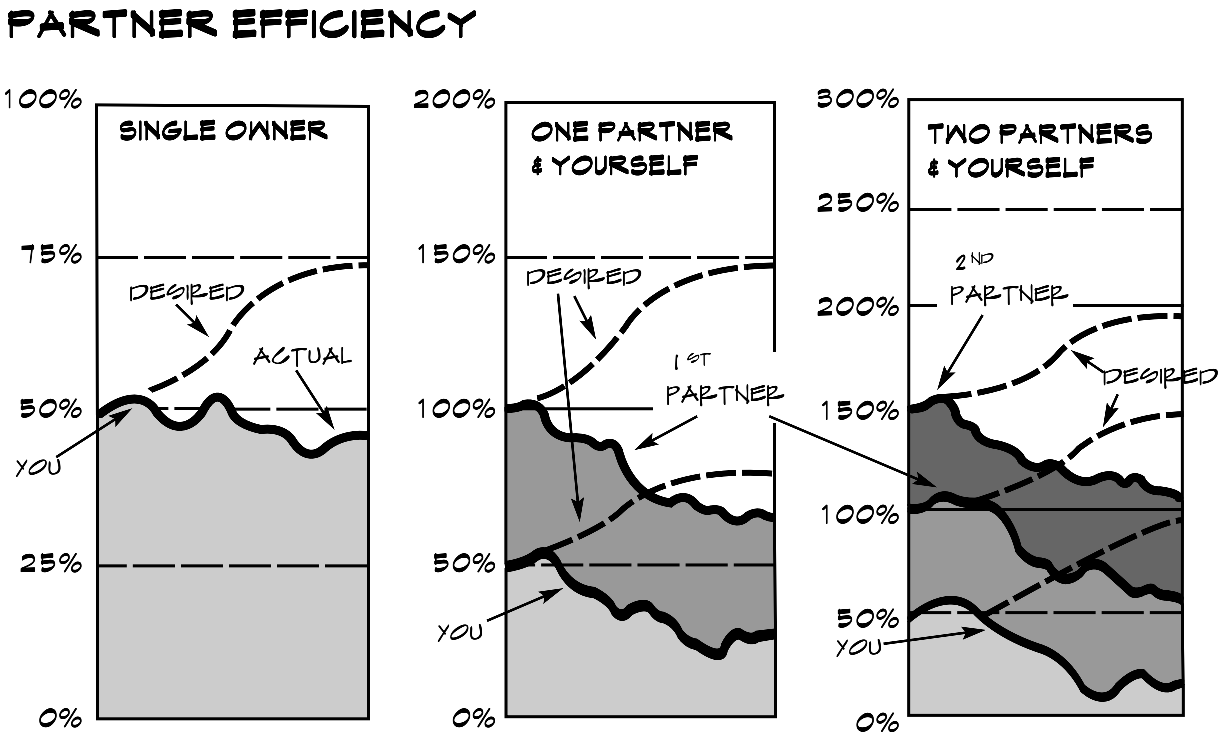
At some time, you're going to consider taking on one or more partners. Operating as a sole proprietor can leave you short of supervisory help, short of talent, and short of capital to tackle larger, often more profitable jobs.

If you have all the talent and cash you need for the near future of your business, you don't need a partner just to get more supervisory capacity — a foreman can do that. Partnerships generally work best when the partners complement each other: the new partner brings something to the business that you're missing, such as a specific talent, or additional working capital. For example, a new partner might have design, engineering, or accounting skills which you don't have. Alternatively, depending upon what you consider to be your own strengths, you might take on a partner who is an experienced supervisor, estimator or salesman.

It's also an advantage if the partners complement each other's temperament. If you're somewhat introverted and good at the construction activity, but don't particularly enjoy the more extroverted sales aspect of the business, you may want your new partner to excel in both of these two roles. There are probably as many reasons to form a partnership as there are potential partners in the construction industry. But there are also some disadvantages to partnerships.

The danger in any partnership is that each partner tends to lose some of the incentive to make the company succeed. Each participates only partially in the profits and shares only partially in the losses. It's like a team of dogs pulling a sled. Sometimes you can't tell who's doing most of the work, and who's just going through the motions. And if suspicions creep in that one isn't pulling his weight, things can quickly go down hill. So be sure you can communicate freely with any partner you consider taking on board.

The more principals a business has, the greater the chance that some partner(s) will not be pulling his/their share of the load. With a number of partners sucking cash out of the business in the form of salaries, work has to be done efficiently. Many partnerships end up going broke or breaking up just to avoid bankruptcy. See Figure 7-1.



Partnership efficiency
Figure 7-1

There's nothing quite as efficient as a unit of one. If you're a sole proprietor/contractor, the chances are good that you'll cut waste and overhead to the bone. You may be 60 percent to 80 percent efficient. That's actually very good — no one is 100 percent efficient. Add one partner and you both may be operating at between 40 percent and 60 percent efficiency. With two additional partners, odds are that you'll only hit 20 percent to 40 percent efficiency. Add a few unproductive employees and the biggest worry you'll have will be meeting the next payroll.

Here's the key to successful partnerships, in my opinion. It guarantees that each partner pulls his share of the load or suffers proportionately the consequences of failure. *Make each partner's salary proportionate to the income he produces for the business.* How do you do that? It's easy. Lay down a rule, at the very beginning, that at least 50 percent of each partner's time should be directly billable to customer projects. Every partner should record his time spent on every job, and that time should show up in the charges against some billable project.

Of course, the customer doesn't have to know that he's paying for a certain number of hours of a particular partner's time. But, it should be recorded in that partner's time records. If the job one partner is working on isn't producing any revenue for the partnership (i.e. isn't billable to a project), the salary for the partner working on that unbillable job should reflect the loss. That way, there's likely to be very little wasted effort and time. If there are more than two partners, the ratio of billable-to-unbillable time should be higher than 50 percent, more like 70 percent.

Make every partner's income proportionate to the revenue (and ideally the profits) he produces for the partnership. That way you'll have no trouble with unproductive partners. If you let partners work on nonbillable projects, or you hire unproductive employees, you're going to attend a lot of prayer meetings — partners gathered around the conference room table wondering where the money for the next payroll is going to come from.

If you're going to be in business with one or more partners, make sure you start out right. Begin with a set of common goals. If you and your partner(s) aren't heading for the same destination, you'll waste too much time pulling in different directions. Put your goals and expectations on paper and pin them to the wall where you can all see them easily. Refer to them frequently and revise them when necessary. Keep an eye on these goals and judge your success or failure by them.

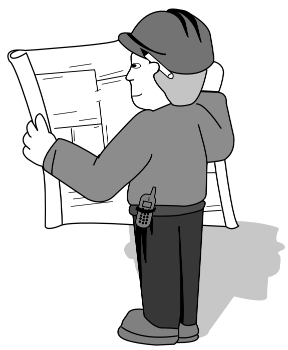
Be sure to have a legal document spelling out all of the details of the partnership and the obligations of each partner. You won't need it when everything is going along fine, but you'll certainly need it if things turn ugly. It's too late to start thinking about putting your partnership on a legal footing at that point. You can find all you need to know about forming a legal partnership, plus the necessary blank forms, in *Contractor's Plain-English Legal Guide*, by Quenda Behler Story, published by Craftsman Book Company (see Appendix 4).

"Put your goals and expectations on paper and pin them to the wall where you can all see them easily."

And remember that a partnership is a lot like a marriage. Get to know the spouse and family of prospective partners before signing a partnership agreement. Your partner's spouse could turn out to be a real ally or a serious adversary. Anybody can get along with anyone when business is good. It's when the business is unprofitable that partners become argumentative and partnerships fall apart.

Job Supervision and Your Foreman

Big construction companies can afford full-time foremen who don't work with tools. On a $5,000,000 project the foreman doesn't have time to drive nails. But you won't see many jobs like that just yet. If you're a multi-million dollar contractor, you probably aren't reading this book. For most small builders, a non-working foreman is a luxury they can't afford.



Your foreman should never be a spectator. Contractors with straw bosses don't make money in residential or small commercial building construction. Every construction entrepreneur has to be efficient. Efficiency begins with you, and extends through your foreman to every man and woman on the payroll. A foreman can work as a carpenter, plumber or electrician without sacrificing his efficiency as a supervisor. Ideally, he needs to have a broad range of skills. You'll need him to be on-site for most of the duration of the project, whereas a dedicated framer will only be on any one particular site for the early stages of construction. And he needs to be a good example, as that's the most effective form of leadership. Don't tolerate a foreman who thinks working with tools is beneath his dignity and only does so occasionally and with reluctance.

The best kind of foreman is also an expediter — someone who does professional work in the shortest possible time. He ensures that all tools and materials are in place and ready to go at the start of the day. He's ready to overcome any obstacle that might slow down the job. He can tackle any part of the work that needs his attention. He's always one step ahead of his crew, planning what they'll do next, so the tools and materials are ready when the men are ready for them. He's willing and able to chase down materials, do take-offs, keep time cards, coordinate trades, dig trenches, tie steel, pour concrete, drywall and paint, if necessary. He keeps things running smoothly and profitably, and makes sure the job is finished on or before schedule.

Your foreman should understand that he's there to make money for his boss, not the other way around. If you sense that your foreman is only going to be with you for a short while until he can go off and start his own business, you may have the wrong man for the job. Not that I'm against ambition — I'm all for it. But this is your business, so you need to find a foreman who'll stick with you for the long haul, get to know how you think, and be coming to you with suggestions as to how to improve the operation, rather than you having to drive him. So when you find the right man, encourage him, give him clear goals to meet, and let him know that if he meets his goals he'll get a piece of the action. After all, he'll have earned it.

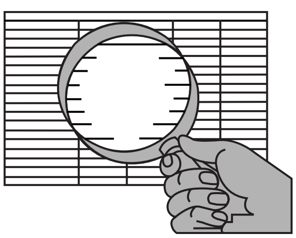
Finding the right man and keeping him is a tough problem. It could take you a couple of years and six or eight trials before you find the right one. But once you have found him, to paraphrase the song in "South Pacific," never let him go. Do whatever it takes to keep him — he's worth his weight in gold. But don't let him get the impression he's indispensable; no one is, and if he ever starts to feel that way, his performance will be sure to suffer. It's a fine balancing act that you'll need to master. Keep ratcheting up his goals and you'll keep him on his toes.

Don't hire any foreman until you really need one. A three- or four-man crew shouldn't need a foreman, provided you can be on-site for a good deal of the time. *The minute you hire a dedicated foreman your profitability drops off, at least temporarily.* Don't take on help, unless and until you're sure you need it. Better to run lean and work some overtime than to have employees standing around looking for work.

Here's one final point on supervision. Don't assume that hiring or appointing a foreman relieves you of the complete responsibility of supervision. It doesn't. Somebody still has to supervise the foreman. Nobody has your interests at heart quite like you do — however good they are. But supervising your foreman should take less than 10 percent of your time, leaving you the other 90 percent for other productive tasks that only you can do, such as prospecting for clients and getting the next contract, handling problems with unhappy clients and, perhaps most important of all, collecting the money that you're owed. If supervising your foreman is taking more than 10 percent of your time, you've got the wrong man for the job.

Problems and Reacting to Them

One of the things you want your foreman to do is to anticipate on-site problems before they occur. He should have the complete project picture in his head, and know what has to be done down the road, so that one tradesman doesn't do something that will have to be undone by another one at some future point. He mustn't let concrete be laid down where electrical cable conduit runs later on. Doing work that has to be undone is much worse than not doing it at all. It costs you three times — once to do it, once to undo it and once more to re-do it.



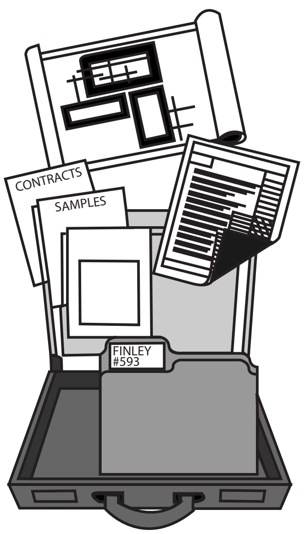
In addition to on-site problems that you expect your foreman to look out for, there are off-site problems waiting to jump out and bite you. Many of these are what you might consider out of your control. And some of them will be, such as the general state of the economy. But the one thing that isn't out of your control, or at least shouldn't be, is your business. You have to anticipate problems that are both in and out of your control and adjust your business to respond to them. And after you've got some experience at it, you can even take advantage of problems.

Many positive-thinking people say there are no such things as problems, only opportunities. It's the way that you *react* to problems that makes the difference. If what you or your employees do just magnifies the problem, then you've really got problems. Unfortunately, this happens to a lot of people — they just make the problem worse. You have to learn to recognize problems, and see them as opportunities to demonstrate how well you can perform under pressure. Your client doesn't know how good you are at pulling rabbits out of hats until you have a chance to show him. Think of problems as opportunities to impress people that you might not otherwise have. It takes a certain mentality to do this, but once you've mastered it, it'll be an asset to your business.

Expecting the Unexpected

I could name at least a thousand problems that can occur in the construction business every day. And part of mastering construction contracting is preparing yourself materially, emotionally and financially to deal with these problems as they come up.

Experienced builders learn to handle problems routinely and turn them to their advantage. They expect the unexpected, and find a way to get the job done and get paid no matter what obstacles get in the way. But no construction contractor will survive long enough to become an experienced pro if he can't overcome the most common construction problems —Contracts, People, Materials, Insurance and Bonding, Taxes, Accidents and Mistakes, and Payments.



Contracts

Your biggest contract problems will always be non-performance — your client can't, or won't, do something that he promised to do, or he claims that you haven't done something that you promised to do. Most, if not all, of these contractual problems can be solved upfront, by writing a good contract. It's when the contract is unclear that you can run into problems. We'll spend some serious time on this topic in Chapter 13 in the Thriving part of this book. Your business will never thrive until you've mastered the art of writing a good, clear contract, and one that is relatively advantageous to you, the builder, rather than to your client. There are some new CD tools available to help you customize your contract to meet almost any conceivable situation, described later in detail.

People

People problems are exasperating, because they seem to be the most unnecessary. But your employees have their own lives to live — they're not just there for your convenience, so get used to them doing the unexpected. Your foreman quits in the middle of the busiest month, your framer breaks his hand, your bookkeeper quits to get married and your plumbing sub decides life's too short to spend time working, and goes off to live in a commune. You need to have back-ups in mind, preferably on a piece of paper. Spend some time thinking about what you'd do if any one of your employees is no longer available, for whatever reason.

"...anything that can go wrong will go wrong, and it will always go wrong at the worst possible time."

Maybe you'll be able to get someone from a temporary employment agency, such as "Rent-A-Tradesman," on short notice. Search out and contact such a company long before the need arises, and convince yourself that the people they would send you are competent to do the job, and that you've negotiated the best possible terms upfront. Tell them that they'll get all your business in return for a good discount. When the crisis does occur, it's no time to start looking for a replacement and trying to get a good deal. You're now at the disadvantage, and the owner of the agency knows it, he'll try to take advantage of you, if he possibly can. Have your replacement plans in place and you'll rest easier at night because, as we all know from Murphy's two laws, anything that can go wrong will go wrong, and it will always go wrong at the worst possible time.

Materials

There are countless reasons why materials are not there on-site when you need them. Someone forgot to place the order. The supplier lost the order. The supplier was out of stock. The factory was on strike. That particular item is no longer available. The material got lost in transit…. If you don't get short-shipped, you could get the wrong items, broken goods, or second-class merchandise. Of course, not all of these problems are going to occur all of the time. But you can be sure that, over a lifetime in the construction business, each one, and lots more, will occur some time. So it's a matter of being prepared for any and all eventualities.

Fortunately, beating materials problems is relatively easy if you use at least a couple of suppliers for your most common materials needs. And with the advent of the big box stores, such as The Home Depot and Lowe's, it's fairly easy to find most of the materials you need all in one place. Be sure to sign up at The Home Depot ProDesk (or the Lowe's equivalent) and negotiate the best discount you can. Then you can fax in your orders and the store's staff will have it ready for you to pick up when you arrive.

However, it's usually good practice to keep a small stock of all the common items that you use all the time. Also keep a minimum stock of those items that you only need occasionally but when you do need them they are very hard to find. They can hold up the job for a long time if you have to try and find them on short notice. Of course, any stock you carry is money tied up in inventory that could be used for something else, such as paying wages. But it's better to have a small amount of cash tied up in inventory than having your staff spinning their wheels waiting for material that you can't get your hands on.

No matter how good your ordering system is, don't rely on the materials you need always being available exactly when you need them. Your suppliers, no matter how good they are, don't have the same interest in the success of your business as you do. When you know something important is due next week, make the call and ask if it'll be there on time. If you don't get a straight answer keep pushing until you do. If you're still not confident, place a second order at another store — it's rare that you can't cancel it, if the original supplier does comes through, unless it's a special order.

Liability Insurance

Liability insurance and bid and performance bonds are a necessary part of being in the building contractor business. Don't ever think of trying to operate without liability insurance; you could be wiped out in the event of a serious accident.

In addition, a major loss might be uninsured because of a loophole in the policy. After all, who bothers to read and fully understand insurance policies? Find a good insurance agent who specializes in building contractor insurance coverage and bonding. Then give him enough business so that he recognizes you as an important client. Bonding and liability insurance cost money, of course, which you may ill afford. But my advice is to overestimate your insurance and bonding needs. It's much better to be over-insured than under-insured. Being under-insured can be a double whammy. First, you pay the premiums (when you'd rather be saving the money for something else), and then, when you have a loss and you find that the insurance policy doesn't cover it, you have to pay for the loss.

Bonding

Bonding is a slightly different matter. Depending upon the type of clients you have, you may not need to provide a bid bond or a performance bond. But if the type of contracts you're bidding on require them, you've no alternative but to comply.

Your bonding limits may be quite low to start with, until you've built up a reputation with your bonding agency for going through with bids you make, and performing to the contracts you're awarded. Protect your bonding limit and your insurance premium like gold. If you don't, your insurance and bonding agent may supply you with some nasty surprises. Your insurance rates could go up unexpectedly and your bonding limit could be reduced without warning.

Bonding is something that you do by choice. First, you decide what kind of builder you want to be. If you select certain types of work, especially local, state or federally funded projects, you'll usually need to be bonded. To find out if you're bondable, call your insurance broker. He'll explain the requirements and the costs. If you can't afford the premium for the bond level you need, you'll just have to continue cooking in a smaller kitchen until your finances improve.

Getting a performance bond is a lot like getting approval for a bank loan. The qualifications are about the same. If you plan on doing commercial or government work as a general contractor, you're going to need a performance bond on most jobs. If you're in poor financial shape, bonding may be impossible. You'll have to concentrate on residential jobs or do sub work for another contractor who *is* bonded.

Construction performance bonds guarantee that the contractor will finish the work at the agreed price. The need for bonding is obvious. Contracts generally go to the lowest bidder, whether they can finish the work at the price quoted or not. Too many contractors, stuck with what has become a money-losing contract, have just walked off the job. That leaves the owner of a partly-finished building looking for another contractor to finish the work.

Performance bonds solve that problem. The bond is written by an insurance company. It guarantees that the work will be finished under the contract, even if the original contractor abandons the job. Obviously, the bonding company has to have faith in the construction company it backs — faith that the contractor has the financial muscle, the will and the skills needed to finish the job.

"Construction performance bonds guarantee that the contractor will finish the work at the agreed price."

The bonding company usually protects itself, initially by requiring the contractor to keep at least 10 percent of the bonded amount in cash or securities on hand at all times. As time passes, they may reduce that percentage. But until they really get to know you and your operation, they'll keep you on a tight rein.

Here's an example. Let's say you want to bond a $200,000 job. You'll need to keep $20,000 cash in the bank. Later on, that amount may be reduced to $16,000, $10,000, or even $4,000, as you prove your ability to manage your work load, and as you develop a good job completion track record.

Each time you bond, you'll have to update your Financial Statement or Balance Sheet on file with the bonding agent. The volume of bonded work you can do can't grow unless your bonding capacity grows. If your bonding capacity is $200,000 and you're already doing a job for $180,000, you can only bid another job (that requires a bond) for up to $20,000. If you want to bid another $75,000 job, you'll either have to wait until your first job is nearly finished or get your bonding capacity increased. If you can't afford to raise your bonding capacity because you can't afford to keep more cash in the bank, and you aren't close to finishing the first job, your only alternative may be to get your "cash in the bank" percentage requirement reduced to less than the present 10 percent.

If you want to take on jobs that require bonds, build a strong relationship with an insurance agent who handles bonds. Your agent can intercede with the bonding company on your behalf. If he has faith in you and your business, bonds will be as simple as they can be.

You may have to try several agents and bonding companies before you find one that appreciates your business. Not all insurance agents handle construction bonds. Deal with an agent who specializes in construction bonding.

Unless you plan to be the biggest contractor in town, there's a limit to the bonding capacity you'll need. Look at it this way. Suppose you find that you're comfortable with jobs in the $200,000 range, and running two or three of them at a time is enough to keep profits flowing nicely. Your bonding requirement is only $400,000 to $600,000. There's no way that you'll ever need a $1,000,000 or $2,000,000 bond.

As we discussed earlier, a high volume of work often reduces your profit margin and generally increases complexity. So find your bonding niche and stick with it. Avoid the over-expansion mistakes that plunge many contractors into financial ruin.

There aren't many ways to beat the bonding system. One thing you can't do if you want to get a performance bond is to work on speculative projects. That's an absolute no-no. Bonding companies are scared to death of any involvement in projects like spec houses that are built and paid for out of the contractor's pocket. As far as they're concerned, if you want bonding, you'll have to forsake spec building completely.

If you want to participate in a speculative project and still be bondable, do it with a partner. You can do the actual construction but the bonding company should understand that there's no risk on their part.

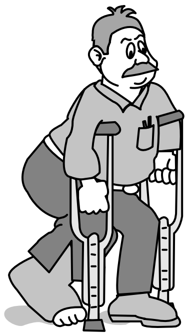
Taxes

As the saying goes, "There's nothing so certain as death and taxes." The tax man will leave you alone if you take your taxes seriously and pay them on time. I don't recommend it, but if you do decide to do your own salary checks, which we covered in Chapter 6, you'll have to learn all about withholding taxes. Getting behind in paying your withholding taxes is courting serious trouble. Your business might be locked up, your cars, trucks, and equipment impounded and your receivables seized. It's not smart to fool with Uncle Sam.

However, that's one surprise that's relatively easy to avoid. Just decide you're going to play by the rules, which are very well spelled out in *IRS Publication 334: Tax Guide for Small Business*, available from your local IRS office, by phone at 1-800-829-3676 or on the internet by typing into your internet browser, www.irs.gov/publications/p334/index.html. If you play by the rules your business should be fine, at least as far as the tax man is concerned.

Accidents and Mistakes

An accident or a mistake could quite literally kill you or one of your workers. We've all heard the expression "an accident waiting to happen." Fortunately, they're fairly easy to recognize. A well-run job is a safe job. A tidy work site is generally a safe work site. But you have to keep your eyes open and your wits about you all the time on a building site. You have to learn to preempt accidents. For instance, if you're doing any welding on-



site, make sure the gas bottles are tied to something sturdy and can't fall over. A gas bottle that falls over and breaks off the pressure regulator is like a live torpedo and can do untold amounts of damage in no time flat. Accidents take seconds to happen and often years to recover from. A frequent walk-around of the building site, looking for accidents waiting to happen, is time very well spent.

Keeping everyone informed will prevent many mistakes. Consider having an occasional job safety conference or progress meeting. It may keep the plumber from digging up the electrician's power line and the concrete trucks from driving over a newly-laid drain line. Keep your job site picked up and your materials organized, and you'll prevent most accidents and dumb mistakes. If you do have a serious accident, you'll have OSHA, the Occupational Safety and Health Administration, all over you like a ton of bricks. That's not something you want to contemplate, so take safety seriously; it might be your own life that's in danger.

Equipment

I think half of the equipment I buy has legs — it's always walking off the job. And the best stuff seems to have the strongest legs. Broken equipment never seems to have any inclination to leave.

Every contractor will admit that good equipment is hard to keep track of. The best control method I've found is the old ball monitor routine we all learned in elementary school. Start by scribing an identification number on each piece of equipment you own. Keep the ID numbers in a master record and keep the equipment locked up whenever possible. When it's not possible, be sure one person has responsibility for checking the equipment out and checking it back in again. Checkout authority might rest with a foreman, a purchasing clerk, or a secretary. Anyone who needs equipment or supplies checks them out with the responsible person. The individual in charge physically checks the equipment out to someone by name, date, and identification number, and notes the condition of the equipment.

Commercial equipment rental yards operate this way and so should you. Do this and at least you have some idea of where your equipment is. If something's missing, you know who to go and see.

Keep in mind that the cost of missing tools, nails, gas, or materials reduces your profit, dollar for dollar. Any loss avoided increases your profit by that amount.

Payments

Finally, start planning to get paid the minute you write the contract. How well you write the contract can have a significant bearing on how easy it will be to collect what you're owed. Don't assume that you'll get paid just because you did the work. You have to work at getting paid. Stay in touch with your client and his accounting people. Get your invoices in on time, or early if possible, but not too early. If you're too early he'll think you're over-anxious and may get concerned about your financial viability. On the other hand, he may put them in a pile and forget about them.

Make sure that the invoice is clear and detailed. Most reasons, or should we say excuses, for not paying invoices on time are because the client says he doesn't understand what he's being charged for. Spell out the payment schedule in the original contract, and make your progress payment invoices match the contract so there shouldn't be any dispute. Include evidence with the invoice that the progress step has been met, preferably with the client's signature on it, so he's already agreed to make the payment. Keep a record of your client's checking account number and know where he does his banking. When he says his check's ready, tell him you'll come by and pick it up. Don't accept him telling you it's in the mail. We've all heard that delaying tactic a thousand times.

Losing Time

Let me give you a short lesson in wasted time. I used to work for one of the country's largest architectural-engineering companies. They had 1,200 employees. I estimate that each employee wasted an average of at least 15 minutes a day — not to mention only partially productive time, like many meetings. The cost works out as follows — 15 minutes times 1,200 employees equals 300 hours a day wasted. Multiply that by five days a week and you get 1,500 hours a week. Now multiply by 50 weeks and you get 75,000 wasted hours per year. Multiply by the billing rate of, let's say, $60 per hour to get $4,500,000 a year in unbillable time. Now, if the average wage is $25 an hour, the real outflow of cash to payroll is an additional $1,875,000. That's a total of $6,375,000 annually in real money lost. Keep in mind that we're talking about wasting only 15 minutes per employee per day. It's easy to waste that much time.

Figure 7-2 is a Time-Waster Chart. It should give you some idea of where you stand on this issue and just how devastating wasted time can be to your business. Let's bring an example of wasted time down to numbers every contractor can appreciate. Say you have five employees and each one spends an extra 30 minutes a day on coffee breaks. The annual cost to you will be roughly $30,000 if your employees work at a $50 per hour charge-out rate.

Maybe your crews don't take an extra 30 minutes for coffee breaks. But that's not the only kind of wasted time there is. Does the lumber delivery truck driver drop off his load at the far side of the lot so your crew has to spend the next two weeks manually hauling studs and joists 50 yards to where they're actually needed? It happens all the time. How about placement of sand and gravel? Does your roofing supplier drop his tiles at the curb line instead of on the roof? Did the heating and plumbing subs hack

TIME WASTER CHART

TIME WASTED ON NON-PRODUCTIVE ACTIVITIES			HOURS PER EMPLOYEE	NUMBER OF EMPLOYEES (LOSS IN HOURS)							
				2	5	10	20	40	60	80	100
1	COFFEE BREAK	0.25 Hrs	0.25	0.50	1.25	2.5	5	10	15	20	25
2	REST ROOM	0.25 Hrs	0.5	1.00	2.5	5.0	10	20	30	40	50
3	SLOW COPYING	0.25 Hrs	0.75	1.50	3.75	7.5	15	30	45	60	75
4	SLOW WORKER	0.50 Hrs	1.25	2.50	6.25	12.5	25	50	75	100	125
5	LONG LUNCH	0.50 Hrs	1.75	3.50	8.75	17.5	35	70	105	140	175
6	EXCESS TRAVEL	0.50 Hrs	2.25	4.50	11.25	22.5	45	90	135	180	225
7	GENERAL GOSSIPING	0.25 Hrs	2.50	5.00	12.50	25.0	50	100	150	200	250
8	MISTAKES	0.50 Hrs	3.00	6.00	15.00	30.0	60	120	180	240	300

NOTE: The hours in items 1 - 8 are cumulative, so as you add more wasted time activities, the amount of lost time expands rapidly. As I've highlighted, if you have 20 employees each wasting 1.75 hours per day = 35 hours per day x 250 work days per year = 8,750 x $50.00 per hour = $437,500 lost income annually.

Time waster chart
Figure 7-2

up your framer's work? Does the duct work have furred space to run through? Is everybody sitting around waiting for you to solve problems like these — problems you should have anticipated?

Think about it. The meter's running all the time. Somebody has to pay the bill. And since the contract price has already been agreed upon, the only one who can foot the bill is you. And the only pool of money that you can tap into is your profit on the job.

Another spectacular time-waster is poor ordering and haphazard delivery scheduling. Lack of materials leaves your workers standing around, unable to do their job. Every $50 lost to wasted time reduces your profit by

$50. And it takes about $1,000 in construction work performed to make $50 in profit. So wasting $50 is like losing $1,000 worth of construction work.

Conversely, any $50 worth of time you can save, compared to your estimate, is $50 worth of additional profit that goes straight to the bottom line. So look for ways you can save time just as aggressively as you look for time being wasted. It soon adds up on the plus side, not on the minus side. One approach is to tell your staff that for every hour they waste (unless it's your fault, of course), they have to find an equivalent hour to make it up (which is difficult for them to do). You'll be surprised how effective this is in avoiding wasted time.

Waste of equipment dollars is nearly as common as waste of time. I've seen contractors buy backhoes and tractors, and then let them sit unused for weeks. That's plain stupidity. Did you ever rent a forklift and return it one day late? That could add a full week's rental charge. Where's your profit now?

Don't let things like this happen in your company. Construction takes careful planning and scheduling. Spend the time you need to run your business efficiently. That's the best way to save both time and money. And most of all, stay on top of the job all the time. If you don't, no one will!

Risk Management

One job in ten is a money-loser, no matter who handles it. Try to spot that job before it gets to you, and then avoid it like the plague. It may not be easy to spot at first, but here's a rule I follow — you can't make money from people who are broke. It isn't always easy to be sure, but you'll develop a sixth sense about this fairly quickly. If the guy you're having a business lunch with seems to be as broke as you are, let him buy lunch — and then find an excuse to leave promptly. If the contracting community is lucky, he won't build anything. If he does, he'll do it a little at a time, and whoever is unlucky enough to get the job will lose his shirt.

If you'd taken his job, your chances of getting paid in full would be somewhere between slim and none. He's wasting your valuable time. Better to go with someone who has a track record of completing projects and paying his bills. If it's his first project, ask to speak to his bank manager to assure yourself that he's got the funds to complete the project before you get involved. If it looks like a job that no one else wants to take on, there's probably a good reason for it, and it may be best to avoid it altogether. But remember, that's one of the niches I've found to be very rewarding — jobs that no one else wants can often be very profitable, if you're certain you've got all your risks covered. You can generally charge a premium for the job, especially if the customer can't find anyone else to do it.

"Contractors who exceed their limits end up in trouble."

Risk can take many forms. Some jobs are inherently unsafe for the tradesmen who have to work on them. If you decide to take such a job, make sure that your staff is fully trained in the jobs they need to perform, and especially that your insurance coverage for that type of work is adequate.

Other jobs have hidden risks that you can't see until you get into the project. For example, let's assume you've been contracted to replace a roof, but when you get the shingles stripped off you discover that the roof deck is rotten. Who's going to replace the roof deck? Not you, you say, but do you have that covered in the contract? Even if you have, your employees now have to wait around until you can agree on an addendum to the contract to replace the roof deck, or the client can get another contractor to do it. All of this wastes time, and will probably cost you money you hadn't estimated. Try to anticipate such problems and have a plan (and an estimate for any additional work that might be necessary) agreed to with the client before you start. Any time there are hidden risks, think through the consequences if those problems should occur, and have a plan in place to cover the eventuality.

Other risks arise when you have to excavate. It's not always easy to know what's underground until you start to dig. You may think it's just dirt, but it could turn out to be solid rock, or there could be all sorts of utility lines buried there. You may need to get an expert company to do some Ground Penetrating Radar (GPR) testing before you quote, but be sure the client has agreed to pay for this before you call the expert in, as it can be fairly expensive. You can get more information on GPR on the internet from such web sites as www.gp-radar.com.

Some jobs simply require more skill, more equipment, or more financial muscle than you possess. Know your limits. Contractors who exceed their limits end up in trouble. Many contractors have taken heavy losses by attempting projects that were either too big or too complex for them.

Many real estate developers have learned to spread their own risk to the contractors they use. Some of these developers start a project with the full knowledge that they don't have enough money to finish it. They expect to sell out the project before construction is complete. If the project doesn't sell, the last contractors or subcontractors to finish work don't get paid. That's why it's more risky to be a drywall, paint, tile, or carpet contractor than a framer.

It's also a very good reason to have a schedule of progress payments in the contract. Make sure you're getting paid frequently, and if there's some expensive item that's required, insist that it's paid for immediately on receipt. If the progress payments are ever slow in coming, stop work immediately and don't restart until the client has caught up with the payment schedule. Of course, this will cost you money in having your staff stand around, maybe doing nothing, until they can start work again. Try to include a clause in the contract that the client will pay for this wasted time if it does happen. If he intends to pay on time, he should have no difficulty in agreeing to such a clause.

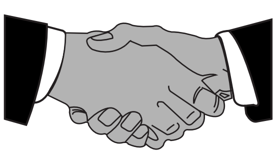
As I've said before, there's nothing wrong with taking risks, but remember that's very different from taking gambles. Risks can be assessed and planned for. Gambles are just a matter of luck. Many builders and contractors, including myself, thrive on risk. But it's important that you evaluate the risk thoroughly before accepting the job. Along with the higher risk should go a higher reward. If the reward isn't there, don't accept the risk.

The ideal client brings very little risk. Look for well-financed corporate clients who must build because their business is growing. The electronics, energy, recreation and food industries, as well as senior citizen housing, have shown good growth over the last 10 years, and I see no real reason for that to change in the next 10 years. Find clients in these industries and grow with them as they grow. That's a formula for success in the building industry.

The Labor Relations Board

Most states have a Labor Relations Board (LRB) that's authorized to hear employees' complaints against their employer. The law usually provides that employees have to be paid within a certain number of days of the end of a pay period. If an employee isn't paid he can complain to the Board.

A financially-troubled contractor will soon learn to hate the Labor Relations Board. They act as a free attorney for your employees, and double as the judge during any hearing.



The Labor Relations Board will teach you to fire employees the minute it looks as though you won't be able to meet a payroll. The worst thing you can do is to hold on to your workers, hoping that you'll be able to pay them later or at the end of the month. Once the grace period has passed, you can guess where your employees' next stop will be — the Labor Relations Board.

All employees have the right to seek help from the LRB if they're not getting paid. After all, it's not their fault; you're the one who has failed to perform. It's no defense to claim that their work was shoddy or that they made costly mistakes. It's your job to provide sufficient training and supervision to see that that doesn't happen. *The only issue is whether they worked and didn't get paid.*

The LRB will probably assess fines against you for unpaid wages. These fines are based on the salary of the employee(s) involved. The bigger the salary, the larger the fine. The typical LRB penalty will be $50 per employee for each day they remain unpaid. That can add up fast for a crew of five employees.

The penalty assessment is supposed to teach employers to make their payrolls on time. What it actually teaches contractors is to dump workers the minute making payroll looks unlikely. Hiring new workers later on is a better bet than battling with existing employees at the LRB. Dump and rehire is the name of the game today, regrettably.

The LRB teaches contractors not to bet on economic conditions improving when business is slow. If you bet wrong, the penalties will be heavy. Because of this, many contractors regularly dump and rehire their workers. That's not the best way to run a company, but it's what the law encourages. If you can't make next Friday's payroll, lay everyone off now. *If you can't pay them in full immediately, pay them something each week until the date of your LRB hearing*. Here's why. LRB penalties are computed from the date of the last payment. The board doesn't inquire into the amount of the last payment. Even relatively small payments will cut the penalty substantially. That could be important during a recession, when more employee claims are filed with both the LRB and the courts. It may take several months for your case to be heard.

Here are a few pointers if you're facing an LRB hearing. First, prepare your case carefully. Bring all relevant documents to the hearing — time cards, contracts, and any other agreements with ex-employees. Review your records carefully so you understand exactly what they mean. Don't rely on your secretary or bookkeeper to make your case for you. It's not their problem — it's yours.

"The LRB teaches contractors not to bet on economic conditions improving when business is slow."

Remember, any loss due to an employee error is irrelevant to the LRB. It has nothing to do with any unpaid wages that are being claimed. If you feel that an employee has cost you money, take your case to the appropriate courthouse. The LRB doesn't handle that kind of dispute. Their sole function is to determine what wages are owed.

If the Board decides against you, here's what to expect: A judgment is entered into the public record against the employer — either you personally or your company. *The LRB will provide the employee (claimant) with an attorney if the employee wants to pursue you for payment. Of course, the cost of this pursuit will be added to your fine.*

If your ex-employee doesn't pursue the collection matter, the judgment becomes a lien on any house or other property you or your company owns. When you try to sell it, the lien will show up and you'll have to pay the back wages (plus the penalty) before you can complete the sale.

As you can see, losing at the LRB is just like losing in court. If you're in serious financial distress, you may be able to bankrupt your way out of the obligation.

Summary

A sole proprietorship is probably more efficient than a partnership. Every time you add a partner, efficiency tends to drop. A partnership works best when the partners complement one another, have similar goals and there's some objective measure of each partner's performance which affects their salary. Distribution of income should be proportionate to performance.

Your foreman, if you hire one, should both work and supervise. He should be willing to chase down materials, do take-offs, pour concrete, do framing — whatever has to be done to keep the job on schedule.

Take the time to learn about writing an air-tight contract. Liability insurance, bonding and taxes are part of doing business. Take them seriously and they shouldn't present you with any problems.

Be prepared for accidents, misunderstandings, hikes in insurance rates, strikes, late deliveries, and equipment growing legs. It's all part of the construction business. Preparation, constant checking and careful planning will minimize the impact of surprises.

Lost time chisels away at your profits. Watch those coffee breaks and use the Time-Waster Chart, Figure 7-2. Post it where your staff can see it when they come into your office so they know you're using it.

Risks? They're everywhere. Some risks are worth taking if the rewards are commensurate. But other risky jobs just may not be worth your time, effort or money. If you can't convince yourself that you've got a plan to deal with all the potential risks you can think of, then it's probably best to avoid the project altogether. How much risk you can afford to take will depend upon your financial standing at the time. If times are tough, taking a risky job could wipe you out if it goes wrong. But on the other hand, it could be the making of your company if you've thought it through and got all your bases covered. Ultimately, *the best protection against risk is your own good judgment.* Be sure to use it!

Finally, remember your employees always have access to the Labor Relations Board, so treat them fairly, just as you'd like to be treated yourself.

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The Equipment Payment's Past Due

Most contractors are working so they can be financially comfortable and look forward to a secure retirement. Everyone wants plenty of money, but money isn't everything, even in the construction business. Having the time to enjoy life is just as important, and that's not always easy to find.

For most contractors there's a tradeoff between time and money. You have to work like a dog to become financially independent. This means giving up much of the free time that you see others enjoying. But spend too much time on leisure activities and you may never reach your goal.

Keeping your nose to the grindstone right up to retirement day isn't the answer either. By then, you're probably too old and tired to enjoy the money and time off you've earned.

Here's my philosophy, and why I keep my business as simple as possible. I'm not interested in becoming the biggest contractor in the state. *My view is that obligations and commitments can make you a prisoner of your own business.*

Here's an example. Everyone wants to drive a nice car. The owner of a successful and growing construction company should drive a late-model car, right? So you lease a Jaguar for $600 a month. That's $7,200 a year that comes right out of profits. Though you can probably write off some or all of that as a business expense, it's still a lot of profit lost. If your profit margin averages 10 percent (that's very good, by the way), you have to do 10 *times* that amount, or $72,000, of extra business each year, just to make your lease payments. How many extra hours of your time are needed to generate $72,000 in extra business each year? My guess is that it's more than a few Saturdays, evenings and holidays.

There's another consideration as well. You don't want to look too prosperous — your clients may think you're overcharging them. On the other hand, they don't want you to turn up in a rent-a-wreck either. You'll need to find a happy medium. Exactly how high up the monthly lease payment scale you decide to go will depend upon the type of clients you want. If you're aiming at the multi-millionaire market, you'll probably need that Jaguar just to make the right impression. However, if it's the middle income market you're aiming at, then it's probably best to turn up in a domestic sedan.

But that's just one obligation. Consider a swimming pool, a sports car for the weekends, heavy equipment, office space, trucks, expensive tools, phone bills, taxes, insurance premiums, accountants, lawyers, foremen, secretaries, workmen, and office furniture. Can you see why there's never enough free time? You're just too busy making payments to make any money.

If you ever expect to have any time off, you're going to have to decide which obligations to accept and which ones to decline. Begin by making two key decisions — what kind of contractor do you want to be? How big do you want to get? Figure 8-1 shows some of the tradeoffs between working hours and obligations.

There's no getting around it. Every construction contractor has both personal and business obligations. But some lifestyles and construction work involve more obligations than others. Let's look at a few examples.

Capital-Intensive Contractors

In the construction business there are two extremes — *Capital Intensive Contractors* and *Paper Contractors*. If you own a construction yard full of equipment, supplies and inventory, you're a capital-intensive contractor. Chances are excellent that you're becoming a slave to those obligations.

In a capital-intensive operation, the owner is preoccupied with making monthly payments, the next payroll, putting out fires and meeting with bankers, accountants and lawyers. If he's lucky, he gets two weeks, vacation a year. Most aren't even that lucky. Don't get me wrong. I'm not against owning equipment or running a capital-intensive construction operation. I'm against the strain that this sort of operation can put on you and your family. It takes a lot to be the head of a large construction company — and that's what you are when you own a lot of expensive construction equipment and employ the staff to operate it.

There's a problem that lurks just below the surface for every empire-builder in the construction industry. The incredible cost of the equipment, the labor and the financing are a constant drain. When you're operating a big company, you're forced to take jobs you may not particularly like, just to keep your equipment busy. The need for cash flow may force you to work

EXPENSES VS TIME OFF

	Personal and Business Expense Item	Monthly Payment	Annual Payment	Annual Revenue to Make Payment	Hourly Rate	Hours Worked to Make Payment
1	House pmt.	$1,500	$18,000	$180,000	$50	3,600
2	Food pmt.	$750	$9,000	$90,000	$50	1,800
3	Auto pmt.	$350	$4,200	$42,000	$50	840
4	Utility pmt.	$400	$4,800	$48,000	$50	960
5	Pool pmt.	$600	$7,200	$72,000	$50	1,440
6	Sports car pmt.	$400	$4,800	$48,000	$50	960
7	Insurance pmt.	$250	$3,000	$30,000	$50	600
8	Truck pmt.	$400	$4,800	$48,000	$50	960
9	Backhoe loader pmt.	$750	$9,000	$90,000	$50	1,800
10	Bobcat pmt.	$400	$4,800	$48,000	$50	960
11	Scaffolding pmt.	$200	$2,400	$24,000	$50	480
12	Totals	$6,000	$72,000	$720,000		14,400

Expenses vs time off
Figure 8-1

with people you don't particularly trust. Business pressures may require you to abandon your self-respect just to keep your company afloat.

General contractors with loaders, backhoes, and heavy trucks are slaves for their bankers. Supporting a heavy payroll can make you a slave to clients who deserve neither your respect nor your time. Disputes with irate owners, lenders, employees and other contractors are inevitable. What's the result? You spend countless hours solving problems rather than building.

If you're always chasing payroll and fending off hostile clients and loan officers, *stop*. There are other ways to make a living in the construction business. Don't get caught up in an endless merry-go-round of loan payments and payroll. But let me add a word of clarification before we move on. These are just my opinions, of course, and there are many owners of large successful building contracting businesses who manage to do very well for themselves and their families. It's fortunate for us all that there are, otherwise the country would grind to a halt for the lack of building capacity. It's just that I prefer to keep things small — as your business progresses you'll have to make your own decisions on how much you want it to grow.

Paper Contractors

Here's my favorite description of a paper contractor — a builder whose major piece of equipment is his license. Paper contractors don't exactly work without people and equipment. It's just that they severely limit that kind of involvement and they hand-pick their jobs.

The nice thing about paper contracting is the low overhead. The insurance cost is minimal, payroll is small, and loan payments and withholding taxes are insignificant. Robert Frost, America's poet, once said, "Take care to sell thy horse before it dies, the art of living lies in passing one's losses on." Paper contractors pass their expenses on. Do you?

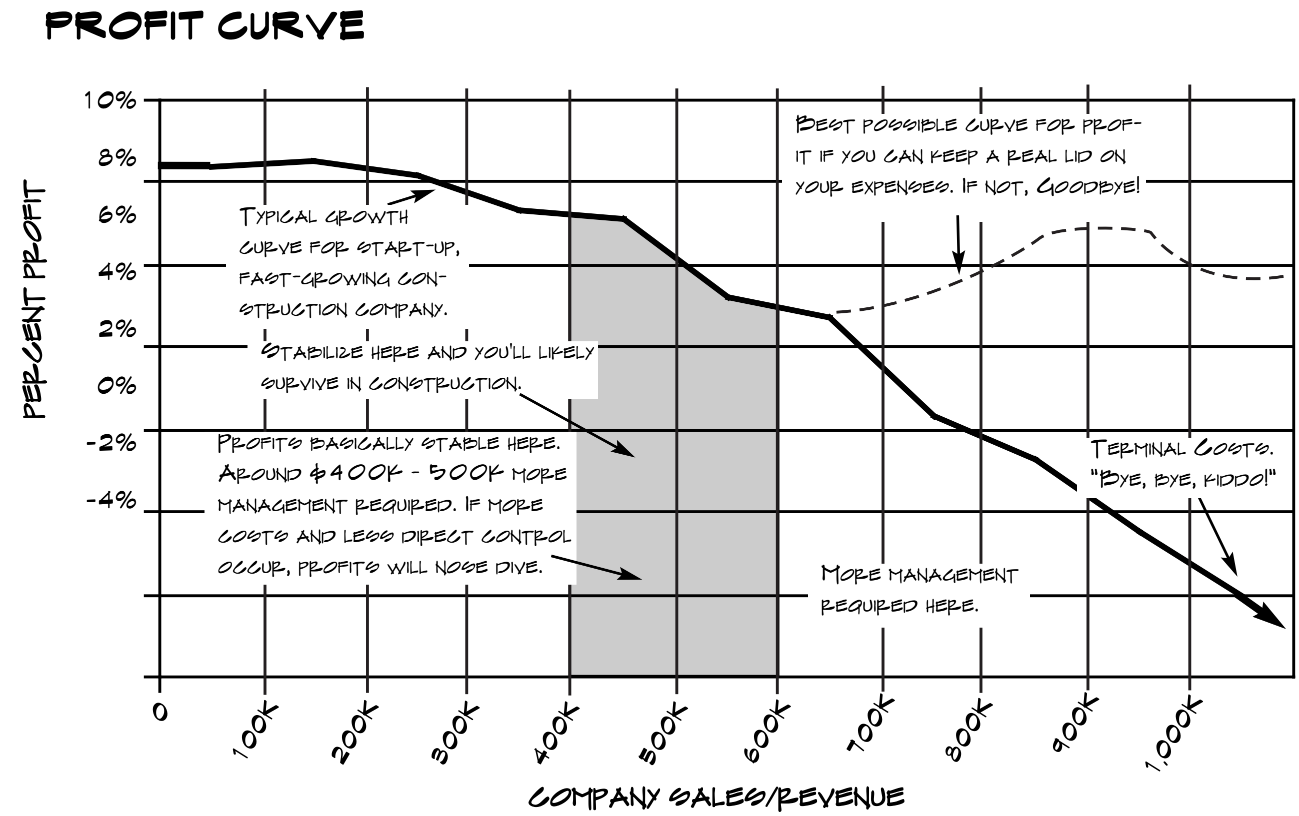
As a paper contractor, you can pick and choose the jobs you take and the people you hire. Of course, you'll use more subcontractors than you'd have to as a capital-intensive contractor. But that, too, has its advantages. There's always someone to blame when the plumbing, electrical, or drywall work isn't up to par. Someone else's insurance company will handle the claims. Someone else has to worry about collecting.

Paper contractors need little office space. Your den, or even your dining room table, may be plenty. Accounting and utility costs will be minimal.

The whole idea behind paper contracting is to get control of your life and your business. It's hard to remember that the objective is to drain the swamp when you're up to your adenoids in alligators. The problems of a big construction company can take up so much of your time that you lose sight of your original goal — making a good living so that you can enjoy life.

Paper contracting gives time back to you and your family. Workload is reduced by 50 percent or more. Of course, gross income is lower. But that's no problem if obligations drop proportionately. And that's the other half of the paper-contracting adjustment. There's no way to keep your current staff when you reduce your work load. So cut overhead, staff, equipment and interest expense, and you'll do well as a paper contractor.

In an earlier chapter, I suggested that the more work a construction company does, the smaller the profit margin may be on each job. That's because you may have to include less profitable jobs in your job mix to make up the volume. Let's look at the other side of the coin. It's time to do less work and make more profit per job. See Figure 8-2.



Profit curve
Figure 8-2

Remember, if you do only four or five jobs a year, there are only four or five owners to deal with. Each client gets more of your time. When you build less, you can do more of the actual work and supervision yourself. That cuts the payroll and reduces the number of subcontractors. And by doing more of your own supervision, you should be able to eliminate most of the errors that have cost you thousands of dollars in the past.

All in all, working as a paper contractor offers many benefits. About the only things you have to lose are your problems.

Doing Your Own Work

Look, I know you're tired. It's all that worry and effort you've been putting into "fire fighting." The odds are you spend most of your time correcting yesterday's mistakes, covering your checkbook, stalling the bank and your lenders or meeting with your attorney.

Actual construction work is only half as tiring as the mental strain of financial problems. The trick to stabilizing your business in the construction industry is to simplify your life. You do this by reducing the number of potential problems you have to deal with. And remember — there's nothing wrong with doing your own work, with your own tools and skinning your own knuckles occasionally.

There's something therapeutic about doing your own work. I suspect that it comes from being in control of your destiny. When it's your own hammer that's doing the work, you know at the end of each day what's been done right and what may need some more attention.

Here's another benefit. Working on your own jobs helps rebuild your organization, if that's what suits you. Staying small by working on your own jobs gives you both control and time to think about what you're doing and where your business is going. It also gives you the time you need to get back to solvency if you're in a repayment plan, or recovering from Chapter 7 bankruptcy. Once you've established a solid base of work and a steady income, you can think about expanding.

There's one final advantage of working on your own jobs. When you cut your own materials, there's sure to be less waste. Beams and joists cut too short, the wrong kind of wire, bad taping jobs and other mistakes just won't happen because you're there. Theft should be significantly lower, too.

Equipment Maintenance

No matter how much or how little equipment you have, taking care of it costs big bucks. It's tough to find the money for essential maintenance when you're struggling to make payroll and loan payments. Routine maintenance is always the thing that's put off. It's under your control, unlike loan payments which are under the bank's control.

The cost of equipment also includes insurance, fuel, oil, air filters, maintenance parts, the equipment operator and taxes as well as routine maintenance. See Figure 8-3.

So the total cost of owning equipment is not just the $4,300 payments per month, shown above, but actually $13,275 ($4,300 + $535 + $1,120 + $7,320), each and every month — and that isn't taking into account the loss of profits that those funds could have earned if you had invested them in real estate instead of equipment. Of course, to do a fair comparison, you'll have to deduct the cost of renting each piece of equipment when you need it and for the time spent ordering it and picking it up and returning, etc. But, I'm sure you'll agree it will turn out to be a great deal less than $13,275 per month — that can kind of money each month can rent a lot of equipment!

Monthly Equipment Costs

	Item	Monthly Payment	Insurance Payment	Mainte-nance	Downtime Hours	Downtime Cost @ $60 per Hour
1	Tractor & Trailer	$1,000	$125	$260	35	$2,100
2	Backhoe	$750	$95	$200	18	$1,080
3	Dump Truck	$950	$120	$250	12	$720
4	Bobcat	$400	$50	$100	27	$1,620
5	Forklift	$850	$100	$220	22	$1,320
6	Pickup Truck	$350	$45	$90	8	$480
7	Totals	$4,300	$535	$1,120	122	$7,320

Monthly equipment costs
Figure 8-3

Of all the projected costs in Figure 8-3, the loan payment may be only the tip of the iceberg. What can really kill you lies hidden just below the water line. That's the time that the equipment sits around idle. Don't be one of those builders who buys a lot of equipment, and then doesn't expand his business fast enough to make full use of the equipment and pay for the finance, insurance and maintenance costs. Only purchase a piece of equipment when the cost of renting it, for the times you actually need it each month, exceeds the total cost of owning it.

How Many Jobs in How Many Hours?

It's Thursday, 6:30 am. Your foreman calls. He needs some lumber. The lumber's been ordered but it can't be picked up because you're 60 days past due on your previous lumber bill. Then, your other foreman calls. He needs sheet metal and electrical supplies. Your foreman can't sign on your account at the electrical supply house, so you'll have to do it yourself. But nobody's open for business yet.

The phone rings again. It's the tile setter. Mrs. Andrews is upset because the tile job he's just finished doesn't match the sample you showed her. She wants you to fix it right away, as she has house guests arriving tomorrow.

Also, you have three jobs waiting for bids. Two of them close tomorrow afternoon. You can't find your plumber to get a price from him. Your painter and roofer won't even talk to you because they haven't been paid for the last couple of jobs they did for you.

You go through your messages from the past few days. There are six calls from Mr. Harper. He's more than a little upset. Nothing's happening on his job and he says your framer was only there three days last week. If he doesn't see some progress by tomorrow, he's going to call his attorney.

"...how far can you stretch yourself, your staff, your money and your skills?"

You look at the messages again. You were scheduled to collect a progress payment from Mr. Harper today because you've got $5,500 in payroll due shortly. So far, all you've collected this payroll period is $850. Your wife told you last night that the bank had called to remind you the tractor payment is 45 days late.

As you head out the door to drop the kids off at school, you remember that the phone's on a 24-hour shut-off notice. You owe the phone company $287. *Try to remain calm!* After saying goodbye to the children, you head for your accountant's office. Your bonding agent wants an updated financial statement and a work status report for two bids due tomorrow. As soon as you've pacified him, you have to take a tax deposit down to the bank. The IRS called Tuesday. They said if you don't make the payment by 5:00 pm today, they'll lock up your equipment.

Does any of this sound familiar? It's no wonder you're going nuts. With this load of worries, anyone would. It's time to take a breather, and then decide where you're going to start. In the short term, you've just got to prioritize. Deal with the most urgent issues and work your way through them.

How about taking on fewer jobs? Does that sound a little crazy? Maybe it isn't. There's a limit to the number of jobs you can handle effectively. If you were making good money handling six or seven jobs a year last year, why are you loading up with four more jobs this year? It's only asking for trouble.

Jobs demand attention, financing, and organization. The question is, how far can you stretch yourself, your staff, your money and your skills? Depending on the size and location of the jobs, one foreman can only handle two projects at a time — at best. Now, how many foremen do you have and how long does it take you to complete a job? Three months? Six months?

Let's look at the number of jobs you can handle this way. We'll say you have two foremen. Each can run two jobs apiece. Each job takes roughly six months to complete. So, figure it out. The maximum number of jobs you can undertake successfully in one year is eight. This assumes you're not doing any on-site supervision work yourself. Your duties as the owner are to handle the accounting, finances, taxes, materials, insurance and, of course, the clients. If you're not taking care of these aspects of your business, who is?

The only way to build more than eight projects a year is to increase the number of supervisory and working hours available to you. That means extra staff, payroll, taxes and insurance. It also means that you'll have another foreman to supervise — remember someone has to supervise the foremen — so you won't be home as much as you should be. This will undoubtedly take its toll on your family life. You'll pay the price.

Here are some guidelines to help you decide how many jobs you should take on at any one time:

1) Assume that each project foreman will spend at least 25 percent of his time just keeping general records of what's going on with his projects. So in a 40-hour week, you'll lose about 10 hours of his time to general administration. If that's all you lose, you've got a pretty efficient foreman.

2) If a foreman is handling a project of $500,000 to $1,000,000 or more, assume he can't handle any other work until the project he's supervising is at least 75 percent to 90 percent complete. Project complexity is also a factor here.

3) If you're doing smaller jobs, in the $20,000 to $100,000 range, assume that your foreman can manage no more than three or four projects, at best. And that's only if they're in close proximity to one another — not more than 15 to 30 minutes apart.

4) Assume that you can't do any actual on-site supervision yourself, unless you're handling no more than four projects a year, each of which has a dollar volume of $250,000 or less. You'll have to stick to sales and company management if your construction volume exceeds $1,000,000 and is composed of more than four jobs a year.

5) Finally, keep in mind that whatever volume you decide to take on, it all has to be staffed, managed, controlled, accounted for and the bills collected. If you don't, your business will soon begin a downward slide.

These guidelines should give you some idea of how to judge the number of projects you can take on, with whatever staff you presently have. But now you want to expand your business. The economy is booming and you'd like to take advantage of the increased level of business available out there. After all, you see your competitors growing, so why shouldn't you do so, too?

Growing the Business

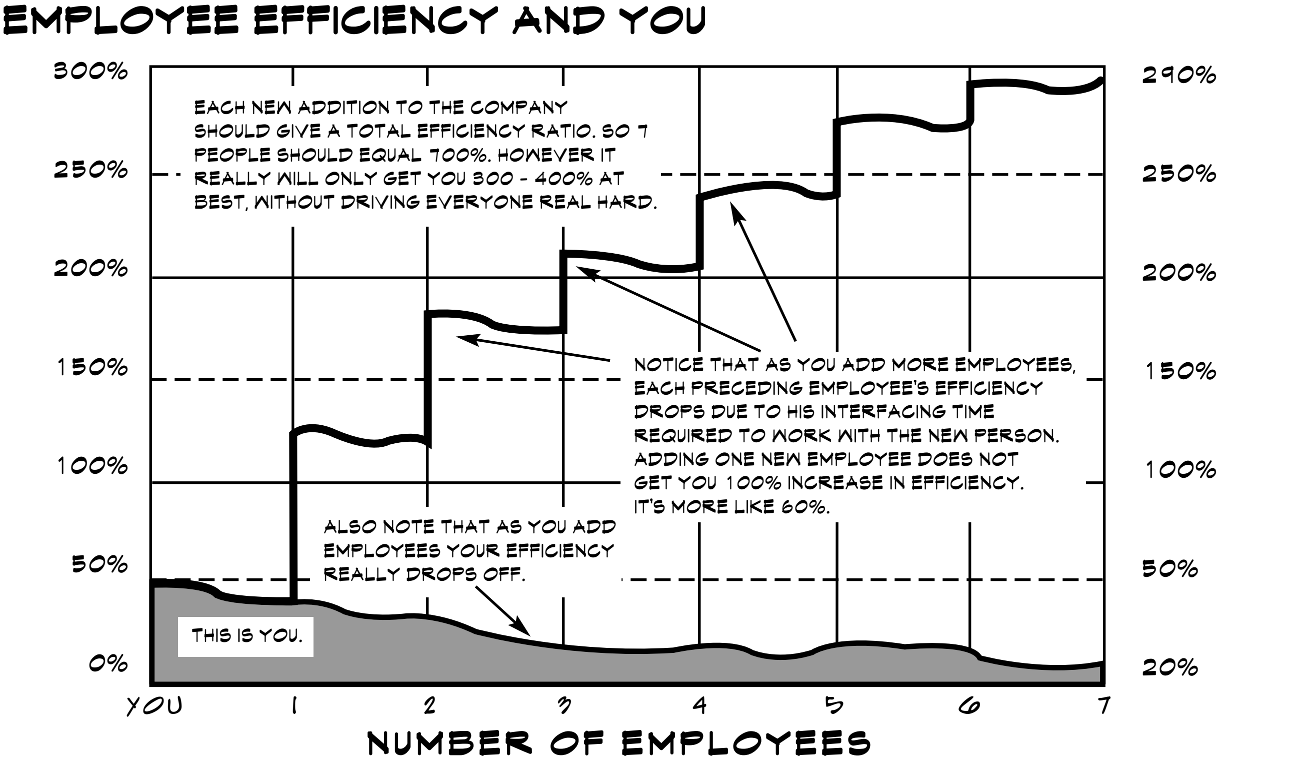
So far we've assumed that you're supervising your foremen directly, and that you can do that efficiently and effectively if you have two, maybe three, foremen and crews, max. So how do companies grow without getting into difficulty? There are lots of large companies around doing very well, so there must be a way.

You want to add another foreman and crew, but there's no way you can supervise four foremen effectively and run the rest of the business at the same time.

Well, you could add another layer of management, by hiring an operations manager (OM) to report to you and to supervise the three foremen you've already got and the one you're going to add. But that just adds overhead that has to be paid for, and OM's don't come cheap. So now you'll be supervising the OM, and he'll be supervising just four foremen, with no other responsibilities, like you have. That's not very efficient is it? This is the real danger period in any business — there's more work to be done than you can handle by yourself, but not enough to be able to afford another layer of management. It's the stage that any growing business has to get through very quickly if it's going to succeed, or it's doomed.

If you see your business volume accelerating rapidly so that you'll be able to take on two more, then three more foremen and crews, then you can take the risk and hire an OM at the same time as you take on a new foreman and crew. Perhaps the OM can double as the fourth foreman for a while, with the commitment that he'll become OM exclusively when you get up to five or more foremen. If you miscalculate, business doesn't grow rapidly and you're stuck at the four foremen and crew level for a long time, you won't be able to afford the OM and you'll have to start downsizing the business, or suffer the consequences.

An alternative approach is to take on a partner, as discussed earlier, to handle some of the foremen supervision and to bring some additional talent and capital into the business. However, the same reservations apply. A new partner will be taking profits out of the company to pay for his salary. Unless you can double the size of your business quickly (both revenue and profit, remember, as one without the other is worthless), you're going to have to reduce your salary to help pay his. If the business doesn't grow at all, the two of you are going to have to split the one salary that you were drawing before. What a deal! So, assuming that you want to expand the business, make sure that it will grow rapidly enough to justify adding another layer of management or a partner to the operation.



Employee efficiency and you
Figure 8-4

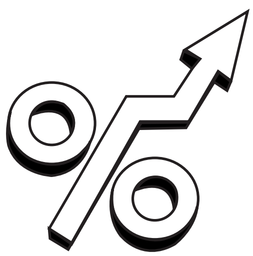
Profits as a Measure of Success

Figure 8-4 shows why a one-man operation will often make the most money for the effort expended. Of course, it will also take more of your time. When you hire your first employees, your profit margin will usually drop. Hiring employees tests your ability as a manager, not as a builder. If you manage employees adequately, watch your man-hours, cut waste, avoid mistakes, keep good books, pay your taxes on time, develop a good insurance program and stay on top of collections, you'll have an excellent chance of avoiding a headlong crash into the zero-profit column. Otherwise, you're just running an expensive hobby.

Profit margin percentage is the best measure of success in your business. Let's say that you hire a few new employees. That increases your payroll but doesn't initially give you a proportionate increase in income, so your profit margin dives. However, as the new employees become more productive, profits will start to climb out of their initial dive and creep back up again like a car accelerating — past 3 percent, 4 percent, and 5 percent to maybe 10 percent or more. Someone in your organization, generally you, has to be watching the profit margin speedometer. You have to avoid mistakes, disputes, thefts, delays, strikes, lost time between jobs, employee accidents, lawsuits, bad investments and everything else that can possibly go wrong. You have to react to pressures that every builder has to deal with — rising interest rates, material shortages, bad weather, high land prices, low buyer interest and government regulations. Profits are extremely sensitive to both internal and external pressures.

Growth and profits are not the same. Don't think of a big staff, a plush office and loads of equipment as indicators of success. Growing is easy. It's paying for growth that's tough. Nothing will shred your cash flow like over-expansion.

Look again at Figure 8-4. Notice that the efficiency curve drops as you add people. Most new employees aren't worth their pay until they learn the ropes and can pull their own weight. *Expanding too fast puts too much dead wood on your payroll.*



Here's how to find the right level of business for your operation. Constantly monitor your profit after all expenses, including your salary. Over time, your profit margin percentage will rise and fall. The question is whether the changes are due to fluctuations in the economy or to decisions made by management. This is a judgment call on your part. But making this evaluation is important to your success as a builder. If profit margins are dropping because you've expanded beyond your ability to control the company, relax. That's perfectly normal. Finish up whatever it is that's draining your profits. Then be more selective about taking on new work, and cut back on your staff to where your profit margin begins to rise again. It could take you six to 12 months to get back to appreciable profit. You'll have enough time to plan your moves, provided you aren't up to your neck in upset owners and legal problems.

Playing the Other Man's Game

Everyone knows that the grass is always greener on the other side of the fence. But a funny thing happens when you get to that greener grass. It still has to be mowed.

It doesn't matter what kind of construction work you do. There's always some guy who seems to be making more money doing another kind of work. I'd like to have a thousand dollars for every time I've heard a hotshot builder brag about how much money he's making. Let me give you a piece of advice. When some loudmouth begins to lay his success story on you, ask him how much he has left over each month after all the bills have been paid. He may be doing $250,000 a month in billings, but he probably ends up with no more than $6,000 to $8,000 gross profit, on which he still has to pay taxes.

"Any contractor making a 10 percent profit, year-in and year-out, is a genius."

Once in a while, you'll run into a guy who really *does* have his act together. He's usually the quiet type. You'll have to press him to talk about his financial affairs. If he says he's making $25,000 profit on a $250,000 monthly revenue, ask him if he'd mind showing you his books as you'd like to learn how he's doing it. If it's true, drop what you're doing and follow him around like a puppy dog for a while and learn his secrets. *Any contractor making a 10 percent profit, year-in and year-out, is a genius.* He deserves all the flattery he gets.

I'm pointing this out because many contractors tend to hop from one part of the construction industry to another, searching for "the sweet spot." I've got some bad news for these guys. They'll grow old before they find it. The sweet spot is any spot that makes something approaching 10 percent clear profit, year-in and year-out. But hitting the sweet spot has more to do with the skill of the contractor who's running the business than with the kind of work he's doing. It's *how* he does it, not what he's doing.

That's not to say that some areas of the construction industry won't be more profitable than others; they will be. But if you keep switching from one hot specialty to the next, you're likely to be one step behind the curve most of the time. You can't wait until some specialty is hot to try to move into it. By then it's probably too late. You have to learn to anticipate where the hot spots are going to be, get there first and stick with it for a while so that you can reap the rewards. You won't always get it right, but if you're right 60-70 percent of the time, you'll be doing very well.

A simple description of a successful construction business is a 10 percent profit margin, sized right, financed right and run right. If you're making 10 percent profit on reasonable volume, you're earning a good living. Learn to be content with what you have, rather than always reaching for something more and risking everything you've built up so far.

Remember, too, that *switching specialties can be costly.* If you're in the concrete business and decide to take up framing, you'll need a different set of tools and equipment. Selling off your equipment will get you only cents-on-the-dollar, whereas buying new equipment nearly always costs you full price.

Maybe you're building medical or office buildings and hear stories about high profit margins in restaurant construction. How long will it take you to figure out the pricing and scheduling? How long will it take you to develop a list of reliable subs who handle restaurant specialties? Do you have the cash to support yourself while you learn all the angles? How will you convince owners to give their business to you rather than to the builders who already have a good reputation in that field? If you're going to have to low bid to break in, that's not going to give you the big profits that the others guys are making. So what's the incentive to switch?

Switching specialties isn't a very practical idea for most builders. Stick to what you know best, unless there's a compelling reason to get out of that business. Switch because the prospects for the future of the specialty you're presently in look dismal, rather than because some other specialty you're thinking you might try looks a lot better. By the time you've established yourself in the new business, chances are that the one you've just left has turned hot again.

Your Working Radius

Every builder has a comfortable working radius — the distance between his home base and his most remote job site. Time spent getting to and from a job can be a killer. Work done out of town may not be as profitable as work done in town at the same price. Figure 8-5 shows a typical working radius.

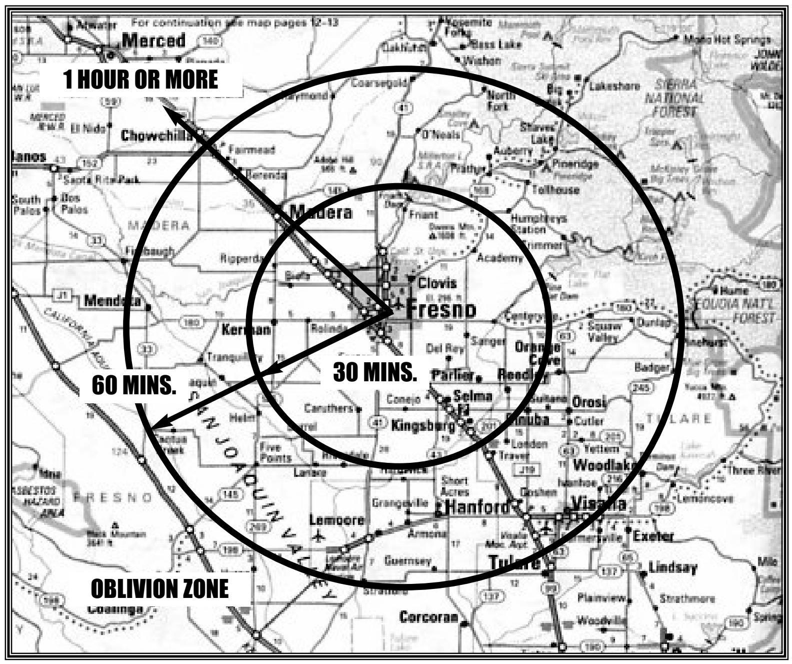
Everybody wants to build within 30 minutes of home. Transportation and lost time are fairly minor costs in that area. But longer drives are tough on people, equipment, and profits. Workers will hire out for a couple of dollars an hour less just to stay close to home. You may have to pay a premium to get tradesmen and subs to work on remote jobs.

You can probably cope with projects within a 60-minute drive, although your costs will be higher. Unless you can hire temporary staff or subcontractors who live in the area, avoid any jobs over an hour away from your home or office. You won't be able to hire a temporary foreman — a foreman is generally someone you know and trust to look after your interests. Your foreman won't want to travel two hours a day to get to work and back. And the number of times you'll be on-site to check on progress will be significantly reduced. You can still work on your cell phone while you're driving, but that's dangerous and not really very efficient.

Added driving time isn't the only extra cost, though. Higher phone bills, gas bills, maintenance, taxes, insurance premiums and city licenses are likely for remote jobs. How are you going to stay competitive with that burden around your neck? And how can you look after your local jobs when you're out of town? There's probably a builder in that location who can do the job cheaper than you can, so you're probably going to have to cut your profit margin to be competitive. Is it worth it? It may be something you have to do occasionally to maintain adequate cash flow or to please an existing client but, if it's the majority of your business, you're doing something wrong.

Make sure you keep abreast of the condition of the local economy. If people are moving away from the area because of the poor condition of the local economy and a lack of jobs, you'll find it increasingly difficult to find

WORKING RADIUS



Working radius
Figure 8-5

profitable projects. If, for instance, the federal government decides to cut back on military spending and your locality is especially dependent on military contracts or bases (as was the case in Southern California in the early '90s), you may need to think of moving to another area of the country where things are happening. We all know that there's a general movement of the U.S. population to the southern states. You may need to follow the trend if your area is going down hill. It won't be an easy decision to make, but it's one you'll need to consider seriously if your local economy is in permanent decline.

Summary

If you want to keep your sanity as a builder, find a profitable niche for yourself. Find a type of work that fits your skills, personality and lifestyle. *Bigger isn't necessarily better.* Capital-intensive contracting can take a lot out of you — perhaps more than it's worth. Paper contracting is an excellent alternative. You can build fewer projects, cut back on payroll, sub most of the work out and do a lot of the actual supervision yourself. The result can be a decent annual profit and fewer headaches.

Don't overlook the option of working along with the tradesmen on your jobs. Usually the only contractors driving nails are those that are new to the business or those that are in financial trouble. For them it makes sense. It's the cheapest and most efficient way to get the job done. Maybe it's the best way for you, too.

If profits are dropping because you're overextended, finish your current jobs and then cut back on staff until you find your optimum level of operation. Make your operation a successful construction business — making 10 percent profit, sized right, financed right and run right.

Resist the temptation to keep switching specialties, chasing the hot new area of construction. Chances are, things will have moved on to the next new area before you've made any money in it. Only think of switching specialty if the mid- to long-term prospects of your current specialty look dismal, not because some other specialty is booming at the moment.

Find the optimum area of business for your operation. Generally a driving time of one hour from your home base is your maximum. If you're frequently taking jobs outside that area, you're doing something wrong. It may be that there just aren't enough jobs in your local area to keep all the contractors busy, and you may have to think of moving. It's a big decision to make. But if your local area is in long-term decline, like many northern industrial cities, you may be better off moving to where there is more business.

So You Can't Find a Job?

It's not easy finding business in a competitive field. And there'll always be competition — get used to it. If there isn't any competition, there probably isn't very much business either. You may sometimes wish there wasn't any local competition, but you should be careful what you wish for — it might just happen. If it does, there's probably a good reason for it. There isn't enough business to support more than one contractor and, eventually, there may not be enough to support even one.

There are many reasons why some businesses succeed and some fail. The product you have to offer, the skill you have in estimating contracts and controlling costs, the way you anticipate surprises, how well you're capitalized and how good you are at landing contracts are just a few of the factors that go into the success/failure mix. We've already seen a number of these, so let's spend some time looking at how you're going to get contracts to work on.

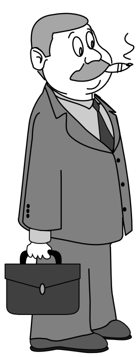
Maybe You're a Lousy Salesman

Many contractors are the world's worst salesmen. You may be one of them. So here's some advice on salesmanship that should stand you in good stead. Salesmanship is a fine art. It takes lots and lots of patience, something most of the builders I know have very little of. Salesmanship takes study, vigilance, practice and, especially, listening skills. It takes know-how, inside information, product packaging, familiarity with your client and being responsive to his needs. In fact, selling is really the wrong term to use, when we're speaking of trying to land a contract. What you're actually doing is helping the customer decide to give you the contract.

It's not about telling the customer what you have to offer, it's about finding out what he wants and persuading him that you're uniquely suited to provide it. Big corporations, small companies and husband and wife couples give jobs to contractors who listen to what they're asking for, appear to have a good grasp of what it is they're being told, and demonstrate that they have the capability, experience and desire to provide what the customer wants in the timeframe he needs it. It isn't always about price; far from it — it's about the customer being confident that you're ideally suited to provide him with what he needs.

"Don't ever get drawn into making a sales presentation on your company before you know what the customer's needs are."

Before you go rushing in to tell the customer how great you are at this type of work or managing that type of project, you have to find out what he really needs — it might be the exact opposite of what you're telling him. It takes patience, I know, because you're just bursting to tell him about all the great projects you've finished recently. Spend some time (but not too much) in small talk, to establish a rapport and get him talking freely. Slowly bring into the conversation questions about his likes and dislikes. Then move on to questions about the specifics of the project he's planning.



Once you've gotten a good understanding of what's involved in the project and what factors are important to him, it's your chance to tell him how your experience and your capability uniquely matches his needs. It may not be something about your operation you would normally have thought to stress, but now you know to emphasize that particular aspect of your whole range of capabilities. You'll need to be quick on your feet, and be thinking while he's talking. From your full range of qualities, you have to decide which one or two you're going to use to match up with his needs. Don't confuse the customer with a whole smorgasbord of reasons why he should give you the contract; just pick those one or two experiences or capabilities of your company that best illustrate why you are ideally suited to do his particular job.

Don't ever get drawn into making a sales presentation on your company before you know what the customer's needs are. Tailor your presentation to what he wants and what's going to help him decide that your company is best suited to do the work for him. If you can't get this information from the main decision maker, talk to some of the junior members of the organization to get as much information as you can, before you make a presentation.

What if a husband and wife team are the customers? Well, before you go to discuss the project, spend some time on the phone with the wife finding out the husband's approach to doing business. This may sound sexist, but it's generally the husband who controls the purse strings in the household, and the one you've got to persuade to give you the contract. His wife will make the decisions about specific styles and colors, etc., but the husband will usually be the one you've got to convince, in order to close the deal. If it happens to be the other way around, you'll soon find out when you make that phone call. Late afternoon is generally a good time to call, when the wife has gotten home from picking up the kids from school and the husband is still at the office. Keep in mind that to close the deal you have to know who makes the decision and that's not always obvious or traditional.

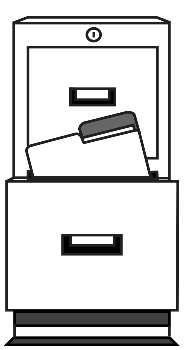
After you've given your reasons why you feel your company is best equipped to do the job, don't be afraid to ask for the contract. If the customer says he isn't ready to decide yet, ask what it is about your offering that he has reservations about. Then you can clarify it and find out what else he needs to hear before making a decision. If you don't ask, you'll never know, and you'll just be left guessing what you need to do to improve your chances of getting the contract.

So who's going to do your selling? Do you even have to ask? You are, of course. It's up to you. No one is going to knock down your office door and drop a contract on your desk.

In addition to learning the skills of selling, you'll need some references. I don't mean a couple of fishing buddies who'll say that you're a great guy. I mean respected members of the community you've done jobs for recently. Make sure the references you give are customers who'll vouch for your workmanship, honesty, sincerity, diligence, fair pricing and ability to meet a schedule. Be ready to provide the name of your bank and insurance company to potential clients. And have your contractor's license ready just in case the customer asks to see it. It should be included in one of the plastic sleeves in your presentation manual.

Don't be a lousy salesman. Learn the skills of helping customers buy from you, and don't be afraid to practice on your wife or partner. You may feel uncomfortable at first, but practice makes perfect. Good selling skills make a world of difference in the jobs you get, the profit margins you're able to attain and the ultimate success of your company.

Repeat Business



Always remember that the easiest place to get new work will be from previous clients. So do your best to generate satisfied customers from each job you do. There's no better referral than a job well done. It takes very little effort to get a second job from a client who likes what you did for him the first time around.

There's another good thing about repeat business. *Your competition has an uphill battle to separate you from an established customer.* Your only sales problem is likely to be pricing, not fighting for the client's trust and attention with fifteen other contractors. And most customers will accept a small difference in pricing to stay with the contractor they know will do a good job for them, rather than risk going with the lower-priced, but unknown and unproven alternative.

If you're being underbid or outsold, whether it's a first time client or a repeat customer, you must resist the temptation to bad mouth the competitor. There's nothing customers hate more than hearing what you think is bad about your competitor. He'll think you've got an ulterior motive. Plus, you'll just make yourself look bad. Tell him about the advantages of doing business with you. And, if he's a repeat customer, remind him how good a job you did for him last time, how you finished on schedule and how proud he was of the work you'd done.

If you know who your main competitor for the job is, and you feel he has some particular disadvantage in that type of work compared to your organization, keep it to yourself, but make sure you emphasize your abilities in that particular field. *The customer will get the message without you having to spell it out for him*. You'll come across as professional, rather than unethical and childish.

"A sound construction business develops a good reputation which sells far more effectively than tens of thousands of dollars in advertising."

If you keep your business in decent shape for five or six years and satisfy clients to the best of your ability, about half of your work will be for repeat customers. Remember, satisfying clients doesn't mean letting them take advantage of you and adding things to the job as you go along without expecting to pay for them. If it's just a little thing, throw it in; it's worth the investment. But clients know you're not in the charity business, they just want you to do what you've both agreed in the contract, to the standard they expect, in the time scheduled.

If the customer wants to make changes or have additional work done, tell him you'll be pleased to provide him with a quote for the extra work. However, don't allow the job to drag on for too long, as you've scheduled your crew to work on this job for a certain length of time, before they move on to another customer's job that you've promised to start on time. If the changes delay starting the next job, either ask the next customer if it's OK to start a few days late, or you must tell your present customer that you'll come back and do the extra work in the near future. Don't let things slide. Keep both customers in the loop and they'll appreciate your openness — these things happen and customers understand it as long as they know what's happening.

A good reputation sells far more effectively than tens of thousands of dollars in advertising. The public knows there are many suede-shoe operators in construction. Every customer wants to avoid con artist contractors. A builder's good reputation separates him from the herd of slipshod, fast-buck artists. Protect your reputation as though it was your life — after all, it really is.

Repeat customers are the best business you can get. They increase your profit margin because you have no sales or promotion costs. There'll be fewer meetings with the client because you begin with a solid relationship.

There may be little repeat business in the first two or three years of your company's operation. But if you do your jobs right, you'll still get some referrals from satisfied clients. Eventually, you'll sow enough seeds to keep the harvest perpetual with minimal effort. A client who's built once is likely to build again. Keeping clients satisfied reduces the effort needed for future sales.

Do yourself a favor. Develop good relations with your clients. Cultivate clients who you expect will build again in the future. You'll profit by the association. Don't necessarily expect to become friends with your clients, but try to at least get into a good working relationship. Call them occasionally and ask if everything about the last job you did for them is still OK.

If one of the faucets you installed in a couple's new bathroom is dripping, it's your chance to drop in and fix it, rather than have the customers constantly reminded of the less-than-perfect job you did for them. While you're there, ask if they're planning any more projects in the future or if any of their friends are thinking of having some work done. It takes very little of your time to make those follow-up calls and it shows the customer you care. Those calls can be the difference between your company's survival or collapse in hard times.

The quickest way to shut yourself out of the construction business is to forget to talk to your customers, or worse still, to avoid talking to them. If there's such a thing as professional suicide, ignoring clients is it. But still some contractors make that mistake. They don't talk to their clients. All your present clients generally want to know is if the project is on schedule and if it will be finished on time. *Tell them!* Explain what you're doing and why. That's a very small burden, in my opinion. And if they're calling up to complain about a problem, putting off a return call won't make the problem go away; it'll just make it worse. Calling frequently can preempt the customer from having to make his complaint call in the first place.

It's the Sixth Time He's Called Today

It's a lot easier if you call the client first, before he feels the need to call you. That puts you on the offensive, not the defensive. If problems are developing on a job, bring the owner into the loop as soon as possible. Keep him fully informed — on both the good and the bad. He's probably successful with good business judgment. He can handle any news you're likely to give him; he's almost certainly heard plenty of it before. What he can't handle, though, is silence. Not knowing what's happening is far worse than knowing there's a problem but something's being done about it. Your silence encourages him to think the worst.

"Poor communication earns distrust."

Your clients are not your enemies. I believe whole-heartedly in this statement and you should too. Sure, there are exceptions. I'll admit that a client can become an adversary when he fails to pay a bill on time. But most billing disputes can be avoided if you provide backup information that explains the bill in detail. If you've supplied the information and you get paid on time, that client rates triple-A in my book. He has the right to be kept informed — after all, it's his money you're spending. That's just fair and sound professional practice.

If you're not getting any repeat business or new customers calling to say they've been referred by a previous customer of yours, maybe it's because you don't keep your current clients informed. Poor communication earns distrust. And no one recommends someone he distrusts. Even worse, unhappy clients may be bad-mouthing your work to potential clients you're discussing future projects with. Projects that might have come your way, without even a recommendation by a former customer, may be going to a competitor because of a negative remark made by an old client.

There's no doubt about it: one unhappy, ignored client can un-sell half a dozen future customers. If you're having a hard time finding and landing new jobs, it could be that you've cut yourself off from the recommendation of previous clients.

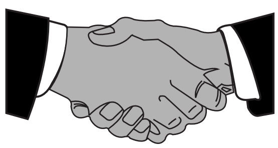
Don't wait for your clients to call you six times before you call them back. *You* be the one to call them six times. You'll earn a good reputation and get lots of future job leads. Every marketing plan begins with satisfied clients and a good reputation in the construction community. It's the easiest and cheapest form of promotion you'll ever get. But you'll still need to do some active company promotion as well.

Promotion and Public Relations

There are a couple of ways to handle your promotional activities. The first is to hire a professional advertising firm or public relations company. The second is to do it yourself.

Very few builders reading this will actually need a professional advertising company. Until you've grown to be a substantial building operation, you won't need an advertising company or a public relations firm. Plan to manage your own advertising and generation of good publicity. You might want to interview several advertising and public relations firms. Ask them for fee quotes, a description of their services and what type of promotional program they would recommend for your company at its present stage of development. From these interviews and descriptions, you should be able to glean enough good ideas to start your own program.

One word of caution: A poorly-focused public relations effort can actually do more harm than good. Be careful not to present a disjointed, incomplete picture of your company and its capabilities. And remember, the first thing you have to decide is what type of construction business you're actually in, before you can start publicizing your capabilities. We talked about that earlier. If you're not sure yet, it's not time to start thinking about advertising and promotion. Go back to Chapter 5 and work your way through that section, until you're confident you know what type of business it is that you want to promote.



Public Relations Campaign

There are many aspects of a public relations campaign, so decide which ones you think will be the most effective, and focus on them first. Public relations and advertising have two major components — generating a favorable impression of your company in the local community and generating leads. Advertising is the relatively easy part, once you've decided what you want to say about your company. So before you spend any money on advertising, let's stop for a moment and think about what other promotional avenues are open to you. Here are a few that might apply in your situation:

- Write an article for the local newspaper or local county home improvement magazine that's delivered free-of-charge monthly to everyone's mail box. You may need to place an advertisement in the same edition, both to encourage the publisher to run your article and to get some leads from the people who read your article.

- Join the Better Business Bureau; attend some of their meetings and make yourself known to as many people as possible — some could be your future clients!

- Join any other appropriate clubs or associations in your area, and offer to give a talk on an interesting topic. They won't let you give a direct advertising spiel, but if you chose a topical subject, like energy conservation in the home, you'll get name recognition for your company, which is just what you're looking for.

- Send a press release to the local newspapers on something you've done recently that's interesting, and then call them up and ask if you can meet with a reporter to expand on the topic.
- Call a local radio station and tell them you're working on an interesting project, and ask if they'd like to do an interview with you.
- Sponsor a charity event. Get a list of the charities active in your neighborhood, and see which ones don't have any or many sponsors. Offer to be the major sponsor (or one of the lesser sponsors, if it's a big charity).
- Contact the local school(s) and see if they need someone to buy the tee shirts for the little league teams. You can put your company name on them, of course.
- Contact the local hospital and see if there's some work you can do for them at cost, in return for an article in the local paper. Being associated with the local hospital is always good publicity.

That should have gotten your creative juices flowing, so I'll leave it to you to complete the list that's appropriate for your area. Most of these activities cost little or no money, just your time. Even when things are going well, you should keep up with these activities as they'll add to your company's name recognition in the community. Now you need to be more specific in adding some substance to that name recognition, and let people know just what type of business this company is in. This is when you need an advertising campaign.

Advertising Campaign

The purpose of an advertising campaign is to promote the type of business you're in, and to encourage people to contact you to discuss the possibility of working for them. There are lots of places to advertise; you see them all the time and we've already mentioned a few of them above. Unless you have some graphics arts skills and a graphics arts software package on your PC, you'll probably want to get a professional to design an advertisement for you, however simple it's going to be. If you're not proficient in graphics design, this is not the time to learn. There are more useful things you can do with your time. Find a local advertising agent who'll produce an advertisement for a relatively small cost — it'll be worth the expense.

Advertising in local publications produces sales leads by keeping your company name and capability in the public eye. Also consider trade journals or other types of specialized magazines. But keep track of the cost and record the number of actual leads and jobs each type of advertising produces. Clearly, the ones that are most effective are the ones that you should keep repeating. And remember, advertising is not a one-shot deal — it's repetition that gets the message across, just as you'll see in the car ads on TV.

However, my experience is that advertising in magazines and trade journals is rather expensive. And it's not always easy to gauge just what is generating the leads for you. Advertising is one way to get your company name and capability known in the local community, but you may decide to spend your time getting free publicity in the local papers or by distributing news releases. Introduce yourself to the publishers and editors of the local publications. What you build or propose to build is news. Local newspapers like to know about new construction in their community.

Recognize that all newspapers have an insatiable appetite for news. If the local paper has a real estate editor, he or she will be happy to receive stories about anything you consider newsworthy. Newspapers will even cover human interest stories that have nothing to do with your construction business, but will get your company name some press coverage. Be sure to ask them to include your company name and briefly describe your business. However, remember that local newspapers are usually distributed free-of-charge, so it's the advertising they sell that keeps them in business. They may run a story for you once without you buying some advertising space, but if you want them to run stories fairly frequently, you're going to have to start buying some regular advertising space from them.

Advertising is expensive and has to be used wisely. If you've decided you need to advertise, set up a budget for your advertising campaign at the beginning of the year and stick to it — and remember — don't spend less if business isn't going very well. That's when you need the most publicity. A few percent of your anticipated gross revenue for the year should be enough for your advertising campaign.

One or two percent of gross revenue is a good guideline. Remember, it's coming straight out of your profits, so if you expect to do $1,000,000 in gross revenue this coming year, your profits should be about $100,000 (i.e. 10 percent), so you can't afford to spend more than $10,000 — $15,000 a year on advertising, including your advertisement preparation costs. But most small advertising agencies will be happy to take you on as a client if you tell them you plan to spend $15,000 a year.

Company Leaflet or Brochure

Have the advertising agency prepare a leaflet (or a small brochure as your company grows) that you can mail to a client before an initial meeting or leave behind afterwards. It should illustrate the type of work you do, list references and mention a few major jobs you've handled. If you're working in one specific area of the construction business, emphasize your capabilities in that specialty. If you're more of a general contractor, keep your leaflet general. Some jobs don't require any particular specialty. Have your leaflet done professionally; if you haven't settled on an ad agency yet, graphics artists are a dime a dozen these days. Don't try to save a few dollars here. The leaflet is your calling card. It's probably more important for sales purposes than the car you drive or the suit you wear.

Here's some basic information to include in your marketing leaflet/brochure. For starters, you'll need the legal name of your company, your business address, phone and fax number, your e-mail address, license number and website address. A website is essential these days, and you're expected to have your own if your company is to be taken seriously. We'll discuss that in a moment. Next, list the building services you perform, your key people, and their background. Finally, list your references. Include a few photos of work you've done, to attract customers in your area of expertise.

Company Website

As I just mentioned, you're expected to have your own website. Unlike your advertisements and leaflets, which may have to go for a year or two before they're updated, your website can be updated constantly. The internet is the modern way of communicating and, if you're not already familiar with it, you'll need to spend some time getting proficient — it's time well spent. But, you'll probably need someone to set up the website for you.

Fortunately, the internet is a very easy way of finding website designers in your local area. Just open a search engine, such as Google or Yahoo, type in *Website Designers* and you'll get a whole list of website designers who are anxious to work for you. You can narrow your search by typing in *Website Designers* and your local area. If all of this sounds complicated, you should attend a PC Users course at your local community college as soon as possible.

Your website designer, or webmaster, will set up your website and do all your updates for a small monthly fee, sometimes for as little as $9.95 a month. And he can do some very impressive illustrations for you, such as 3D views of that new kitchen you just installed for Mrs. Cooper or the apartments you've just built for Dinkowski and Associates. Take a look at the website of one of the major realtors in your area and you'll get some idea of the very impressive illustrations created relatively inexpensively.

Customer Leads

The lifeblood of all business organizations is the ability to generate customer leads. These may come from a whole range of different sources, such as the advertising campaign that we just discussed, friends, acquaintances, club members and recommendations from other professionals in the peripheral aspects of the construction industry.

Recommendations

I've always found the best sources of leads in the construction business are architects, engineers, realtors and bankers. Get to know professionals in these fields locally and start shopping for jobs there. But a referral from a professional like this carries an extra burden. If you make a mess of the job, there are two reputations on the line, yours and the professional who recommended you. So, before you can ask anyone to give you a recommendation, you'll usually need to have a good track record behind you. No one will recommend you unless they're sure you won't foul up. If you don't have a track record yet, ask them if they wouldn't mind mentioning your name as someone that the customer might want to give an opportunity to, as you seem to be professional, sincere and anxious to be given a chance to prove yourself. Give it your best shot — they can only say no. But in the end, nothing counts like performance.

When you find work through the recommendation of a business associate, there's an unwritten obligation to keep that associate informed of progress on the job. Don't leave him in the dark. When the job is complete, take him or her out to lunch. You need to say thanks. Then return the good deed by referring someone to him, whenever you have an opportunity. Favors that business associates do for one another are the foundation of good business relations.

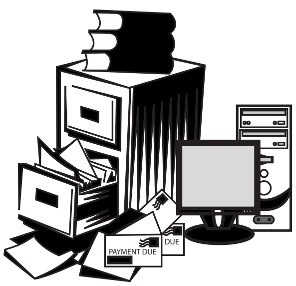
The Prospect List

The key to a successful business is a good list of potential clients. That's your shopping list. It should include at least the following information:

- Name of the Client Organization
- Contact Person and Address
- Phone Numbers (Home, Office, Cell) and Fax Number
- E-mail Address
- Type of Construction — remodeling, speculative or investment housing, or small commercial buildings
- Quality of Construction
- Approximate Contract Price
- Time before Contract Placement Anticipated

- Present Assessment of your Chance of Getting the Contract
- Contact Record and Actions Taken
- Date of Next Contact
- Assessment of How Hot the Prospect is — Use a color highlighting approach, red for hot, yellow for fair and blue for cool

Highlight your best prospects in red to make sure you don't overlook them.



Keep a log of all contacts with clients and follow up each contact with appropriate action. There are lots of software packages available for tracking prospects and other sales activities, but you probably don't need anything as fancy as that yet. Most software packages are multi-layered, with separate click-down pages to enter the name and address information, the type of project and project details, your contact record, etc. It isn't always easy to get a complete picture of your prospect list this way, so I prefer to have all the basic prospect information on one page, with back-up information, drawings, quotations, bids, etc., in separate paper files for each client.

Learn how to use a spreadsheet such as Microsoft Excel and you can set up your own single page prospect and tracking list. You can add to it and change it at a moment's notice. Figure 9-1 shows a typical prospect spreadsheet with information about each potential client and a record of contacts. Set up something similar for your operation.

If you want to build for local publicly-held companies, a lot of the information you'll need will be in the annual report put out by each company. You can get these reports by writing to the company directly. Or you may find that one of the local brokerage houses has annual reports available for the asking. However you get a copy, the annual report will have a wealth of valuable information on revenue, profits, size, market, products and capital spending plans, including construction dollars. Most important, you'll find a list of corporate officers by title.

You're looking for the *Director of Facilities Development* (or some similar title), his address and phone number. Compile a list of the corporate officers in your area who get contracts for construction services. Plan to introduce yourself and contact them fairly frequently. It may take a while to generate business, but you need to plant the seeds before you can expect anything to grow. And, if they have some minor job they just want done that's smaller than you'd normally undertake, take it anyway. It's your chance to show them what you can do.

"Start acting as the local spreader of useful information and your occasional calls will be welcome."

Next, use the civic and business organizations in your community. The Chamber of Commerce, real estate brokers, bankers and city managers all know about building plans long before bids are solicited. These people can provide you with names and addresses of potential clients.

Add the name, address and information on each prospect to your Marketing and Contact Record Prospect List and keep it up-to-date. Each of these people should be sent a letter of introduction to your company and a copy of your leaflet/brochure. And contact them at regular intervals. Try to think of something interesting to tell them, such as a new construction material or technique, or some local construction or business news that you've just picked up since your previous call. Start acting as the local spreader of useful information and your occasional calls will be welcome.

Don't just jump right in and ask if they have any plans to build in the near future — it's easy for the person to say no, just to get rid of you. If you usually give him interesting information, he'll look forward to your calls. When you've got his interest and asked him how his son's baseball team is doing, ask if there's any building planned for the near future that you can bid on.

Your marketing list should eventually include 500 to 1,000 prospective construction clients who may build in your service area in the not-too-distant future. The list will grow quickly if you include the name of every prospective client you meet or hear about. Add just two names a week and the list is over 100 by the end of your first year. Every time you receive a request to bid on a job, add the owner to your list, even if you don't get the contract. Anyone who builds this year is a good prospect to build again in the future.

Using an Excel spreadsheet for your prospect list makes it very easy to manage. You can cut and paste line items, making it easy to move hot prospects to the top of the list. Move jobs you bid on but lost to the bottom of the list. But don't remove them, as they'll probably build again in the future, so they're still a prospect. And remember to highlight your hottest prospects. You can even create a column in which you multiply the dollar volume of each job by the percentage chance you think you have of getting the contract. Then, total that column to give you a rough estimate of your future business volume.

Then, you can plot a graph of your estimated future business level over time, as in Figure 9-2. The chart won't give you precise figures but if you plot it on a monthly basis you'll have a trend line which will help you judge the direction your business is going. It will fluctuate and actually go down as you get a big order, since a client is no longer a prospect once you've got the contract. But if it doesn't climb up again in future months, it's time to start being concerned.

MARKETING PROSPECTS AND CONTACT RECORD

	CUSTOMER	CONTACT	PHONE #'S, ETC.	TYPE OF CONSTRUCTION	QUALITY OF WORK	APPROX. CONTRACT PRICE
1	BIGTIME MANUFACTURING ENTERPRISES 1234 BIGTIME DRIVE, MONEYTOWN, CA	MR BRIAN BIG MISS SUSAN LITTLE (AS)	714-423-XXXX (Off.) 714-423-YYYY (Cell) 714-423-ZZZZ (Fax) Bbig@bigtime.com	FAST FOOD RESTAURANT WOOD FRAME, TILT-UP & MASONRY ON CONCRETE SLAB	MEDIUM/HIGH	$1,200,000 $12-15M Annually
2	MR AND MRS SMALLTIME 3 LINDA DRIVE, ANYTOWN, CA	JOHN SMALLTIME MARY SMALLTIME	714-123-KKKK (Off.) 714-123-LLLL (Cell) 714-123-MMMM (Home) Smalltime@yahoo.com	HOUSE EXTENSION, KITCHEN AND BATH REMODELING	HIGH	$100,000
3	LUCKY PROPERTY DEVELOPERS	JIM SMITH	714-234-DDDD (Off.) 714-234-EEEE (Cell) 714-234-FFFF (Fax) Jsmith@LPD.com	NEW APARTMENT BUILDING	STANDARD	$1,000,000
	TOTAL					

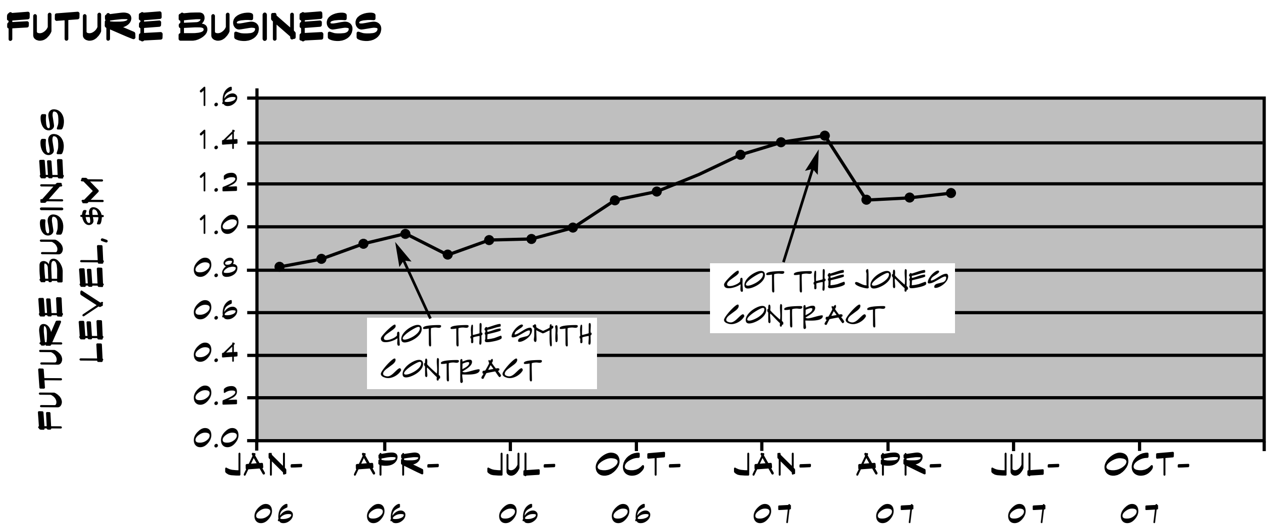
Marketing prospects and contact record

Figure 9-1

TIMEFRAME TO CONTRACT	% CHANCE OF ORDER	CONTACT DATE	CONTACT RECORD AND ACTION TAKEN	NEXT CONTACT	% CHANCE X CONTRACT PRICE
3 MONTHS	60%	3/18/05	INITIAL PHONE CALL TO MR BIG. ASKED TO BE CALLED BACK ON 3/22	3/22/05	
		3/22/05	SECOND CALL TO MR BIG. SAID HE'D CALL BACK 3/24	3/24/05	
		3/24/05	MR BIG CALLED, DISCUSSED PROJECT BRIEFLY, SAID WOULD SEND DRAWINGS AND ASKED FOR A MEETING 3/29 @ 3.00PM	3/25/05	
		3/25/05	SENT LETTER OF INTRODUCTION, LEAFLET AND CONFIRMATION OF MEETING ON 3/24 @ 3:00PM.	3/29/05	
		Meanwhile	REVIEWED DRAWINGS AND PREPARED FOR MEETING, LIST OF QUESTIONS TO ASK AND INFORMATION NEEDED TO PROCEED		
	80%	3/29/05	EXCELLENT MEETING, SEE NOTES IN BIGTIME FILE. AGREED TO PRESENT QUOTATION ON 4/5 @ 2:00PM	4/5/05	$960,000
4 MONTHS	30%		HEARD FROM ARCHITECT. THEY PLAN TO DO AN EXTENSION. AWAY UNTIL 4/12 ON VACATION, BUT NEED TO CALL AS SOON AS THEY'RE BACK	4/12/05	$30,000
4 MONTHS	10%	3/25/05	SAW IN LOCAL PAPER THEY'RE SEEKING PLANNING PERMISSION. NO DETAILS YET. CALLED CITY HALL AND FOUND OUT NEXT PLANNING MEETING IS 4/13 @ 7:00PM. PLAN TO ATTEND AND TRY TO MEET WITH MR SMITH	4/13/05	$100,000
					$1,090,000

Marketing prospects and contact record (cont.)

Figure 9-1



Future business level trend line
Figure 9-2

Flakes, Suede Shoes and Con Artists

Among your prospective clients will be a few individuals who are more likely to waste your time and money than produce any income. *I classify them as Flakes, Suede Shoe Operators, Con Artists and Poor Souls with Good Intentions.* You should be able to spot these characters a mile away.

A *Flake* has about half the money needed to do the job he's talking about. He assumes that you'll work for peanuts in the interest of contributing to the important project he's proposing. He wants you to carry some of the financial load in return for his skill as a deal-maker. Let him pay for lunch and leave.

Flakes almost know what they're doing, but not quite. They have half-baked plans and want you on board to make it all work. They try to drag you into the project with their enthusiasm or play on your philanthropic instincts. But even your best effort won't make the project work. Avoid getting pulled into something that just doesn't seem to have the money to back it up in any meaningful way. *If it feels flaky, it probably is!* As soon as you show any reluctance the *Flake* will lose interest and move on to his next victim long before anything concrete develops.

Mr. Suede Shoes is a different species altogether. This guy can usually be identified by his flashy clothes, gold chains and fancy cars. He carries a wad of credit cards and has no obvious means of financial support. *Mr. Suede Shoes* doesn't know a joist from a girder, but as a self-appointed expert, he's excited by the glamour of it all, the big deals and the high finance.

Mr. Suede Shoes doesn't necessarily want you to put any cash into his project. Of course, he won't turn it down if you offer. *But he wants you to do the job at cost and donate all your overhead and profit, because it's for a good cause.* In addition, he'll ask you to run him all over town helping him put his end of the deal together with the banks. He expects you to do your job and his job too. What a deal! When all's said and done with the suede-shoe developer, you'll find that a lot more will be said than done.

Here's the best way to smoke out the suede-shoe operator. Ask about money. Insist on knowing the dates you'll receive progress payments and the exact amounts. And keep on asking until he either gives you a satisfactory answer or tiptoes quietly off into the sunset.

Next, there's the *Con Artist*. You won't run into the construction *Con Artist* very often, but they certainly do exist, and are becoming increasingly more sophisticated. The construction *Con Artist* isn't like the suede-shoe operator. The *Con Artist* is a crook and he knows it. *Mr. Suede Shoes* just thinks he's a big wheel. The *Con Artist* is generally much less flashy. He seems to be running a legitimate business and dresses conservatively. He wants you to join him in this highly lucrative project, and to put your hard-earned money into what turns out to be a mythical project, to be built on land he doesn't yet own. Of course, he doesn't tell you that. That's for you to figure out. The projected profits will, of course, be very big. The problem is that the project either doesn't actually exist or it assumes loans will be available that no bank would ever dream of making. *In our business, this is known as selling blue sky.*

The best protection, if you've met *Mr. Suede Shoes* or a *Con Artist*, is to run a credit check with one of the three credit reporting agencies. We'll discuss this in a moment. Also get a bank reference from him. Call the bank. They'll tell you in general terms what the average account balance is for a specific customer. If he usually has $15,000 to $30,000 in a checking account, they'll say that the customer keeps "a low five-figure balance." A "high five-figure balance" means that he usually has $70,000 to $90,000 in the account. If the bank says the account is "unsatisfactory," that's all you need to know. Drop him like a hot potato.

Any reputable business person should be willing to give you a bank reference. Anyone who won't almost certainly has something to hide. Don't think of dealing with them for even one moment. Insisting on a bank reference will smoke out or scare off most *Con Artists*. You're getting too close for comfort.

If you decide the customer is on the up-and-up, after investing in the project run a preliminary title search to see if you've been recorded as one of the owners. If not, call the police and your attorney, in that order. Don't call the *Con Artist*. He'll skip town before the police catch up with him if he gets advance warning, leaving you and a raft of other investors with nothing but grief.

Dealing with Mr. Good Intentions

You'll run into many people who think they can get a project built, but lack the skill, the financing or the tenacity to get it done. Many of these people try to use land development as a sideline to supplement their day jobs. These poor souls have the will but lack the horsepower to complete the project they have in mind. Even though they never get anything built, they spend thousands of dollars on detailed studies, estimates and schedules, and can waste countless hours of your time in the process.

Don't be too critical of the prospective client who's sincerely interested in biting off more than you think he can chew. At some time, we've all been guilty of having eyes bigger than our stomachs. I've let my ambition get ahead of my ability and my bank balance several times in my career. Many contractors take on more work than they can handle. When that happens, some jobs have to sit there waiting while others get your attention. Owners of the neglected projects are disappointed, of course, if not irate. Who can blame them? Make sure you learn from your mistakes — those who don't are doomed to repeat them.

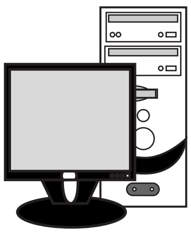
Be fair with *Mr. Good Intentions*, but protect yourself at the same time. My advice is to go ahead and spend a little time with him. Contract your services to him on an hourly basis. It's good for your cash flow. But if you're spending any significant amount of time with him and he's not paying you for it, go on to somebody else who has a real deal in the works. You'll never thrive in construction by wasting your time.

Credit Checks

One focus of your marketing effort must be to sort out the good clients from the bad. That's part of your marketing function — not just finding jobs, but finding sound, profitable jobs. There's no better protection than knowing the people and companies you do business with. This is your best defense against being sucked into bad jobs by fast-talking developers and assorted con artists.

Just as we saw in Chapter 1 about checking your own credit rating, you need to make it a standard practice to check the credit rating of your potential clients. For a small fee, you can get a copy of all the information in your potential clients' credit file(s) from one or all of the three national credit reporting agencies or bureaus: Experian, TransUnion and Equifax. This information isn't available to the general public. An excellent website to check is www.myfico.com. You have to get permission from your clients to review their file. Check a potential client's credit rating before you spend any significant amount of time or money obtaining his business. If his credit isn't good, you haven't wasted your time or money.

The length of time a potential client has been doing business in an area gives you a good idea of his stability and credit-worthiness. And the longer a client has been active in the community, the more history there'll be on him. If your client is new in town, ask him where he's from, and check him out on his home turf. If the information you receive is sketchy, run a preliminary title search on any property he claims to own. Most title companies will do a preliminary search for about $100. It could be the best $100 you've ever spent.



You can now get an ownership report from the internet on any property. Go to www.sentrylink.com and click on Property Search. A brief report will cost you $9.99. You can also get more detailed reports and property value estimates for a little higher cost. And if you really feel there's something fishy about a potential client, you can even click on Criminal Search on the website's Home Page and check if he has a criminal record.

Personally, I find doing credit checks somewhat distasteful. But with so many scams, you've got to protect yourself, so it's the only way. Don't think the customer will be offended if you run a credit check — everyone understands today that it's a normal part of doing business. In fact, they may think you're somewhat slipshod if you don't ask for one, or even that they'll be able to take advantage of you at some point in the future.

The very best credit information will come from people you know and trust who've already done business with the individual in question. Don't just accept any referral name; they could be in on the scam also. Ask other contractors, subcontractors and suppliers about a potential client. Ask about a client's payment record and track record in real estate development.

If you can't assure yourself of a client's sincerity, ask for a reasonably large down payment. If he balks, it could be because he doesn't have the cash. Suggest that his bank issues an irrevocable letter of credit in your favor. If that's impossible for some reason, back away from the deal.

Where's the Money Coming From?

I can't emphasize this too strongly. Understand the full financial arrangements on every job before you start work. As the contractor, you should see where the money's coming from just as clearly as your client does.

It doesn't matter how good a project looks or how much you stand to make out of it, if your client can't finance it. If he hasn't got the money, you haven't got the job, even if there's no competition. That might even be why there's no competition, everyone else has figured out that there's no money in it.

Always ask: — "Where's the money coming from?" and "Who's going to pay me, and when?" Don't start ordering materials until you've got satisfactory answers. Your financial future depends on it.

If a particular lending institution will be the primary source of funds, notify them that you're involved in the project. Develop a relationship with the lending officer who'll disburse the funds to you. Find out how the progress payment procedure is going to work. That way, you can supply the cost verifications and material and labor releases on time and in the form required to expedite payment.

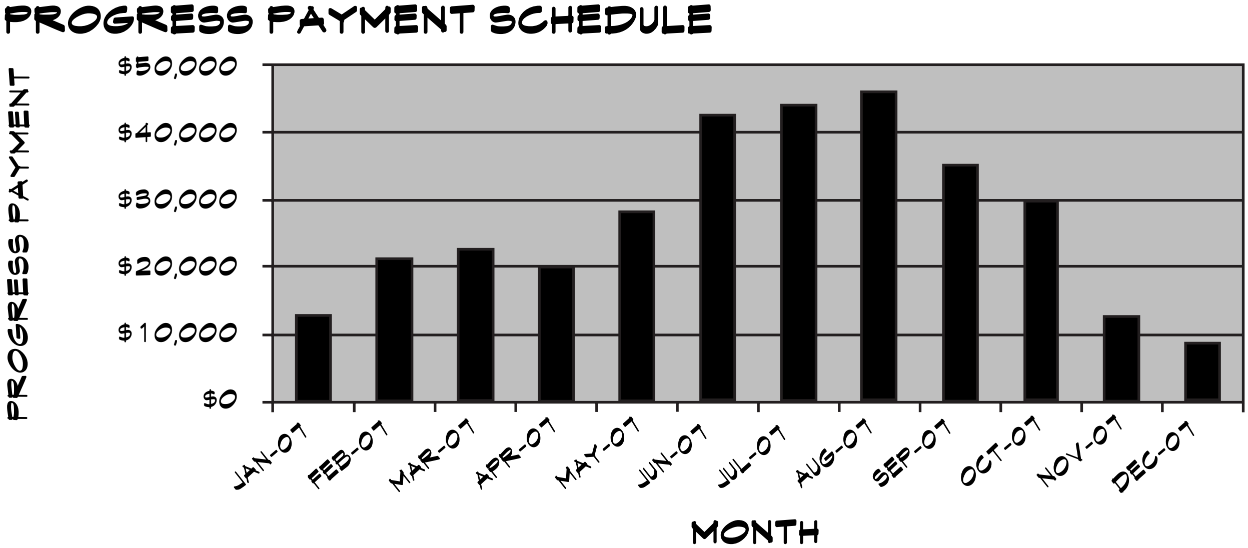
The dates that payments are due should be made clear right from the start. Set up a payment schedule at the beginning of each job, just as you set up a job progress and completion schedule. The progress payment schedule should be based on the construction progress schedule. Once you know how much work is to be done each month, you can predict when progress payments will be forthcoming. That's part of your cash flow planning.

Work out the job completion schedule and payment schedule with the owner and then submit it to the lender for ratification. The schedule may be either simple or complex, depending upon the scale of the project and the degree of detail. Obviously, the more detail, the more complete and accurate the final schedule will need to be.

The payment schedule in Figure 9-3 is a simple chart showing the amount of revenue expected from a particular job for each month of the project duration. You'll want to back it up with a written payment schedule indicating the major phases of the project, the date each phase is to be completed and the amount due for the work in each phase.

Inclement weather will often extend the construction period and may also increase your costs. Your construction schedule should include an allowance for bad weather days. How much time you should allow will depend on your location, the time of year, the kind of weather you can expect and the calendar duration of the project. No matter what estimate you make for weather delays, give yourself some elbow room, especially if there's a liquidated damages clause in the contract.

Another type of delay to consider is delay in payment. A progress payment (or draw) that isn't available when scheduled can cost you dearly in penalties and lost discounts on materials. Here's an example: On a $40,000 lumber bill, the loss of a 2 percent discount for prompt payment will cost you $800. That may not seem all that much compared to the total construction cost. But if the job went for $160,000 and your profit is only 5 percent, the loss of that lumber discount is equal to 10 percent of your profit. That's nothing to laugh at. It can't be repeated often enough — it's the *profit* number you have to keep your eyes on, not the revenue number.

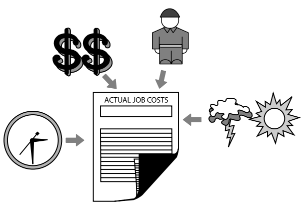


Progress payment schedule
Figure 9-3

Evaluate the chance that you won't get paid on time, and make an allowance for the higher cost of late payment. This is one aspect of what's called adding a *Contingency*, which we'll see when we come to Estimating in Chapter 13. Construction projects are seldom done for less cost and in less time than originally expected. Anything unanticipated nearly always raises costs rather than lowering them. The contingency allowance covers things that can't be foreseen. Of course, it shouldn't be used as a substitute for accurate estimating. But putting an extra 2-8 percent in a bid for contingency is considered good practice by most estimators. On a small commercial or residential job, a contingency allowance of 6-8 percent should be sufficient. If you use a lower contingency figure, you're either an exceptionally good estimator or very optimistic.

Summary

Good relations with your customers are the foundation of your business. You probably don't need a professional public relations firm. But be your own booster. Someone has to promote your company if you're going to succeed. Use marketing leaflets/brochures and free news coverage in local publications to keep your company's name in the public eye. The newer your company, the more important this is, but even an established company needs to keep up its publicity activities. Customers who don't consistently see your company name in print may think you're no longer in business. What potential clients and the public learn about your company is your responsibility.



Build an extensive prospect list and set yourself a goal of adding a certain number of names to it each month. Keep it up to date by making an entry for each new contact. Check it each evening to see what you should be doing for each of your top prospects the next day. If you need to do some preparation for a customer visit, do it that evening — don't leave it until the next morning; you never know what's going to come up to interfere with that plan. Move prospects higher up the list as they become hotter, and down the list as you either close the contract, lose the business or they fail to get their funding. *Your prospect list is your lifeline.* Add a new future business level dollar figure to your Future Business Level chart, Figure 9-2, each month, so you can check the trend of your future business prospects.

Flakes, Suede Shoe Operators and *Con Artists* — the woods are crawling with them. The trick is to keep them at arm's length. That's not as simple as it sounds. The easiest way I know to separate the wheat from the chaff is to talk money and payment dates right up front. *If they don't have the cash, they're wasting your time.* And be sure to keep doing those credit checks; that's an essential part of your business. The one time you overlook doing a credit check will be the one time it comes back and bites you.

Good intentions only count in fairy tales. In business, there are bills to be paid, choices to be made and limits to be set. Good intentions alone are worthless. It takes money, skill and perseverance to complete projects on time and within budget, so you can get paid the full amount of the contract when it's due to you.

PART THREE:

THRIVING

10 **Your Purpose and Goals**

11 **Go Where the Money Is**

12 **Over-Design, Under-Design or No Design**

13 **Second, for the Third Time**

14 **Investing in Inflation**

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Your Purpose and Goals

Hopefully, you're now well past the financial crisis stage and have taken some of the steps that we've been discussing to stabilize your business. It's now time to turn your attention to some of the things you must do to make your business grow and thrive. First, let's look at establishing some goals for your business and for you, personally.

Goal Setting

To thrive in construction, you need to establish some goals. Otherwise, you'll just wander from job to job, handling whatever work is available without focusing on the right opportunities.

What's your purpose for being in the construction business? What are your goals? What exactly do you want from your efforts? You probably got started as a builder because it was something you were good at. You enjoyed working outdoors and with your hands. And there's real satisfaction in putting up useful, durable, attractive buildings. But now you're probably spending more of your time managing the business than actually hammering nails. Is this really what you want to do?

Let me give you a simple lesson in goal-setting that I learned from an insurance broker turned real estate developer. When I first met him, he had just sold his insurance business. With the proceeds, he went into the venture capital business with several partners. During the first year they made only 13 percent on their investments. That simply wasn't enough to live on, so he left the partnership and began investing in real estate. In the next year he more than doubled his money. He told me it didn't take him very long to figure out how he wanted to spend the rest of his life. Several years later I ran into him again. This time he was a multi-millionaire. The secret I learned from him was the setting of goals. He taught me the method I've used ever since. It's really quite simple, yet it's very effective.

Begin each year by preparing a personal financial statement, just as I explained in Chapter 1. This statement is your reference point for the year. At the beginning of the next year, draw up another financial statement and compare the changes for the last 12 months. How much have you gained or lost? What's the change in your net worth? *Are you winning, losing or just breaking even?*

Annual Goals

When making up your financial statement, also make a list of your goals for the coming year. Your goals should be reasonably attainable within the next 12 months, and should cover three main areas:

1) Personal Goals
2) Professional Goals
3) Financial Goals

Under each heading, set three major goals for yourself for the coming year. Figure 10-1 shows some of my own typical goals.

Don't be too rigid in your thinking. Leave a little room for changing or amending each goal as the year goes on. That's to be expected, but do your best to stick to them. Otherwise, there isn't much purpose in setting goals in the first place.

When you've set your goals for the year, make another chart entitled "Goal Implementation." In this chart, write down each individual goal listed below the major goal headings. Then, below each individual goal, list the three or four steps needed to reach that goal. Mine are shown in Figure 10-2.

When your list is complete, pin it to a wall where you'll see it at least once a day. Mark it as you go along, and change it as needed, but work to achieve those goals every day. Towards the end of the year, check your progress — it's your last chance to make good on your commitments to yourself, though it's probably too late to start on the kids' garden in October. Then, at year's end, check how successful you've been. If you're like me, you'll probably meet 50 percent to 75 percent of your goals every year. I know the technique seems naive. But the results aren't. Try it. What have you got to lose?

Committing goals to paper reinforces them in your mind. That leaves you free to consider the "how to's" rather than dwelling on the "what to's." Setting goals also helps influence your thinking. It gives you a clear plan of action that you didn't necessarily have before. And it deprives you of any excuses for doing anything less than the best you can.

GOAL SETTING (FOR 12 MONTHS ONLY)

1 PERSONAL GOALS

A. SPEND MORE TIME WITH THE FAMILY (3 WEEKS' VACATION)

B. LEARN TO PLAY THE GUITAR (SIGN UP FOR LESSONS AND SHOW UP)

C. PLANT A VEGETABLE GARDEN FOR THE KIDS

2 PROFESSIONAL GOALS

A. TAKE A COURSE IN BUSINESS AND ACCOUNTING

B. INCREASE BUSINESS VOLUME BY 15 PERCENT (SPEND MORE TIME SELLING)

C. LOCATE AN OPERATIONS MANAGER WITH PARTNERSHIP POTENTIAL

3 FINANCIAL GOALS

A. INCREASE PERSONAL SAVINGS ACCOUNTS BY $10,000

B. INCREASE BUSINESS CASH RESERVES BY $35,000 (NOW $15,000)

C. CUT ALL PERSONAL AND BUSINESS EXPENSES TO THE BONE (NOW)

Goal setting
Figure 10-1

Lifetime Goals

So much for setting your annual goals. What about your lifetime goals? It's time to look a little further into the future. The place to start is with the major elements that make up your life. Take a look at yourself. What do you want out of life? What do you hope to accomplish? Also look at your family, your business, your professional life, your finances, your assets and your plans for retirement. You're going to try to fit all of this into a lifetime schedule.

First, let's look at your age and what you've already accomplished. If you're sitting at mid-life, somewhere around 40-45 years old, then 50 percent of your lifetime is already gone. You may want to eliminate some of the goals you had as a younger man, such as a new speedboat. A trip around the world might be more important to you now.

If you're approaching mid-life, don't discount raising your family as one of your life's major goals. That's not an easy task in anyone's book — and some people don't do a very good job of it. It's easy to get too tied up in your business and ignore the children — that's something you'll live to regret.

GOAL IMPLEMENTATION

1 PERSONAL GOALS

- A. SPEND MORE TIME WITH THE FAMILY (3 WEEKS' VACATION)
  1. DECIDE WHEN AND ALLOT TIME ON THE CALENDAR
  2. DECIDE WHERE AND MAKE NECESSARY RESERVATIONS
  3. SET ASIDE THE MONEY REQUIRED IN A SAVINGS ACCOUNT — $250/MONTH — DON'T TOUCH IT
- B. LEARN TO PLAY THE GUITAR (SIGN UP FOR LESSONS AND SHOW UP)
  1. FIND AN INSTRUCTOR AND SIGN UP BEFORE JANUARY 31ST
  2. BLOCK OUT THAT EVENING EACH WEEK IN SCHEDULE
  3. BUDGET THE FUNDS SO CAN REALLY DO IT — $120/MONTH
- C. PLANT A VEGETABLE GARDEN FOR THE KIDS
  1. MAKE THE PLANS, TELL THE KIDS, GET ORGANIZED
  2. DECIDE WHERE TO PLANT IT — LET THE KIDS DECIDE
  3. GET THE MATERIALS — SEEDS, FERTILIZER, PLASTIC SHEETING, ETC. — GET GOING

2 PROFESSIONAL GOALS

DO EXACTLY THE SAME FOR BOTH YOUR PROFESSIONAL GOALS AND FINANCIAL GOALS

Goal implementation
Figure 10-2

Make a list of the things you'd really like to achieve in your lifetime. Not little things like starting a new project, but major elements such as paying off your house, a round-the-world trip or a well-funded retirement account. Now, start a new chart and make several headings down the left side of the sheet. They should be similar to the goals in Figure 10-1, only far more encompassing in their scope. The headings should include your assets, family, business, finances, retirement, recreation and anything else that's important to you. Use headings that make sense to you, even though one or two may seem frivolous to someone else. If you want to achieve it, that's all that counts. Your list will look something like Figure 10-3.

Under each of the headings, list the three or four most significant goals you have for each. Be realistic. Each should be attainable in your lifetime. I realize that choosing three or four lifetime goals per category is a tough

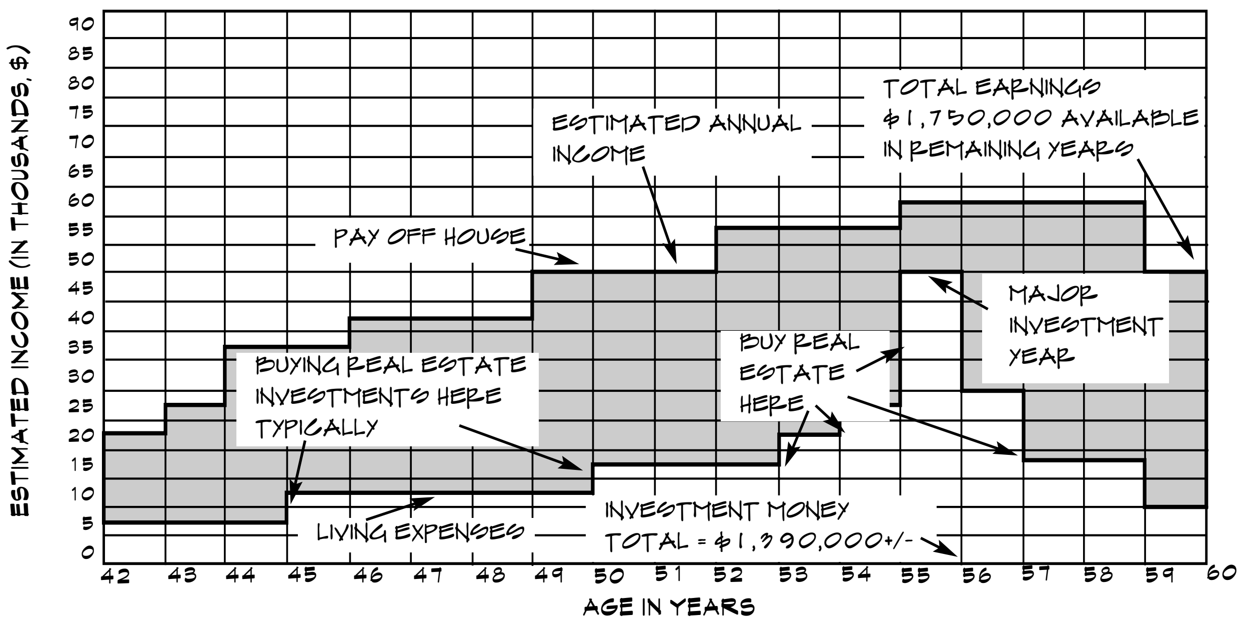
LIFETIME GOALS

GOAL DESCRIPTION

1	**ASSETS REQUIRED**	**$ REQUIRED**
	A. PAY OFF PRIMARY RESIDENCE	$170,000
	B. REAL ESTATE INVESTMENTS ($2,000,000) DOWNPAYMENTS	$200,000
	C. CASH IN SAVINGS ACCOUNT	$50,000
2	**FAMILY DESIRES**	
	A. FORM A FAMILY PARTNERSHIP	
	B. SETTLE DIFFERENCES WITH THE KIDS	
	C. TAKE A MAJOR TRIP WITH MOM AND SISTER - WE'LL PAY	$20,000
3	**BUSINESS DESIRES**	
	A. BECOME A SENIOR PARTNER IN A MAJOR CORPORATION	
	B. BE PART OF AN ASSET DEVELOPMENT CORPORATION	
	C. BUSINESS SELF-OPERATIONAL BY AGE 60 SO YOU CAN TAKE TIME OFF AT WILL	
4	**FINANCIAL DESIRES**	
	A. ANNUAL INCOME TO BE $150,000 FROM ALL SOURCES BY AGE 60	
	B. MEDICAL, LIFE AND LONG-TERM CARE INSURANCE PAID IN FULL	$50,000
	C. NO OUTSTANDING BILLS OR OBLIGATIONS EXCEPT MORTGAGES	$250,000
5	**RETIREMENT AND RECREATIONAL GOALS**	
	A. WELL-FUNDED RETIREMENT ACCOUNT, IRA'S, 401K'S, ETC.	$500,000
	B. TAKE A TRIP AROUND THE WORLD	$50,000
	C. TAKE 6 MAJOR INTERNATIONAL VACATIONS	$60,000
	D. BUY AND PAY OFF OUTBOARD BOAT (SKI TYPE)	$40,000
		$1,390,000

Lifetime goals
Figure 10-3

FINANCE, GOAL AND TIME PROJECTIONS



Finance, goal and time projections
Figure 10-4

proposition. You're likely to have many more than that. If that's the case, go back through your list and cull out a few choices that are more like milestone events than lifetime goals. Take out the goals that are actually short-term desires, such as a new automobile, an ATV or a trip to Bali.

When you've reduced the list to a handful of key personal goals, it's time to establish the cost of each one. Some of your choices won't carry a price tag. But for those that do, estimate what the cost will be. See the "$ Required" column in Figure 10-3. At the bottom of this column you'll notice a total amount which I call the "Bottom Line." This is your estimate of the cost of meeting your lifetime goals.

Next, compare the "Bottom Line" figure with your estimated lifetime earning capacity. Start with a simple graph, which I call "Finance, Goal and Time Projections." Look at Figure 10-4. On this graph, mark your goals. Compare your goals and your income potential. Spread the cost of your goals over the time required to meet each one.

The Finance, Goal and Time Projection chart is your roadmap to personal and professional success. It puts your life's purpose in perspective and should provide a clear picture of where you're going with your life, your business and your finances.

A Realistic Look at Retirement

Many builders end up at age 65 ill-prepared financially to slow down and enjoy the fruits of their labors. For that reason, I believe it's important to start to plan for your retirement from the very beginning of your productive career.

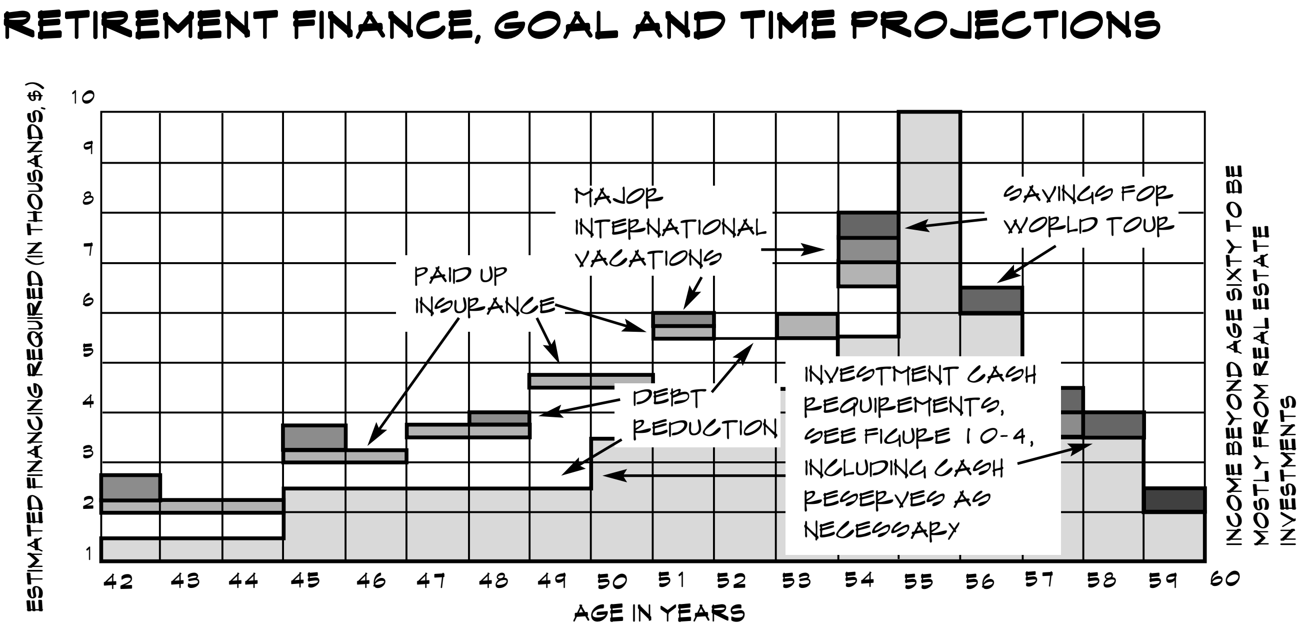
At best, your working years begin at age 18 and extend to age 70. This productive time span is 52 years, the time you have available to save whatever you need to retire. But, you're now most likely quite a bit older than 18. That gives you less time to meet your retirement needs. And you'd probably like to retire no later than 65 and perhaps even at 60, so that gives you even less time.

If you're never realistic about anything else in your life, be realistic about retirement. No one should plan to work forever. Part of being realistic is setting reasonable goals in those five important areas in Figure 10-3. Work your retirement needs into a Finance, Goal and Time Projection chart, like the one in Figure 10-5. Now, let's itemize the assets you need for retirement.

First, you need a source of retirement income. That income should come from investments in stocks, mutual funds, bonds, IRAs, 401Ks, etc., as well as rental properties and retained assets (your multipliers, as we'll discuss in Chapter 11). You might also plan to take some retirement income from the business, as a board member or retained consultant. Hopefully, some form of Social Security will still be available to you in retirement to supplement your retirement income. If you plan to sell the business when you retire, perhaps because you don't have any children or relatives who want to take over from you, then the proceeds from the sale should fund a very nice annuity to provide you with substantial income in your retirement.

Next, you need to build your own retirement reserves. These reserves aren't the same reserves your business has. If your business is to continue after you retire, it will need to be building reserves of its own.

Retirement reserves are anything of real value that can be converted to cash if you become ill or incapacitated prior to retirement. It doesn't have to be cash. It could be any asset that is easily liquidated in time of serious need. In fact, converting assets to cash too soon is usually a mistake. That ends the inflationary growth that many non-cash assets enjoy, especially real estate. Generally, it's best to let them float on upwards with the inflationary bubble as long as possible. It's usually a serious error to keep your entire retirement reserve in a savings account in the bank, often earning



Retirement finance, goal and time projections
Figure 10-5

less interest than the rate of inflation. There are so many financial vehicles available for retirement planning these days that it's far better to use a financial planner than to try to manage your retirement funds yourself.

Only liquidate retirement assets early when there's a dire need, not just on some frivolous whim of the moment, such as that new 60-inch plasma TV that you just have to have to watch the upcoming Super Bowl. Liquidated and spent assets are very difficult to rebuild, and the time available to rebuild those retirement assets gets shorter every year.

"Be realistic about your future. Get organized and protect your lifetime plan."

Retirement years should be debt-free years. Try not to have any major loan payments on cars, boats, furniture, college tuition and the like when you're retired. The mortgage on your home should be paid off, if at all possible. To achieve that may seem to require a lot of money. But every successful builder should be able to handle it during his working lifetime, if he focuses on it. Labor swaps and discounts can cut the building cost of your home to about 30 percent below the going rate. An advantage like that should let you accelerate the payment schedule on your home loan, so that your mortgage can be paid off at least five years before your retirement.

Plan to have a good non-cancelable health insurance plan for your retirement. Once the kids have flown the nest, life insurance isn't so important if you've managed to build up your retirement assets. If you haven't, term life insurance may be your only choice, even though the cost is high at retirement age. Long-term care insurance is something you should arrange as you approach your planned retirement age, so that you're covered in the event you have to spend any significant time in a nursing home. Their monthly rates are astronomical. If you don't have long-term care insurance, the cost could easily wipe out all the retirement assets that you've laboriously built up over the years.

Be realistic about your future. Get organized and protect your lifetime plan. Start a retirement program as soon as possible. That way you'll be ready when the time comes. Recognize that retirement planning is much more complex than I can cover in one small section of this chapter. Get some good legal and financial planning advice; the law is changing all the time, and how it will affect your retirement will depend upon choices you make during your mid- to late-working years.

Your Work and Your Company

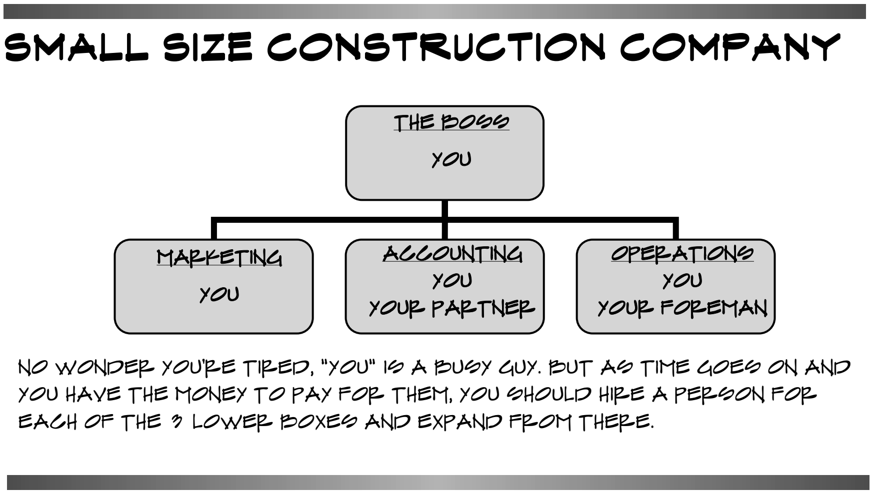
At least half of the construction companies operating today have very little, if any, direction. They bounce from one barely-profitable project to another until the owner either gives up because of financial problems or finally gets around to developing a good business plan with carefully selected and attainable goals.

What type of company are you running? Form a clear idea of what type of business you're building and where you're going in the construction industry. Remember, the kind of business you build does not have to be limited to just your present trade specialty, size, location or working radius.

The most stable construction businesses fall into one of two types. The first is the small, closely-held, family-operated firm that's handed from father to son as each reaches his most productive years. Its success is based on the skill and hard work of the owner. The second type is a much larger corporation that sells stock to the public. Its success depends on its financial muscle and its hired managers, allowing it to compete effectively in the construction market.

Decide which type is a good model for your business. If you're like me, you'll decide to strive for a small, profitable, closely-held company. But that's just my preference — it doesn't have to be yours.

The next decision you should make is which type of construction work or trade specialty do you want to focus on? Do you want to be a general contractor, framer, sheet rock hanger or fire-sprinkler specialist? Pick out your



Small size construction company organization
Figure 10-6

niche and stick to it as long as that business sector is viable. However, keep an eye out for any signs that your chosen sector is declining, and don't stick with it until the dire end — switch to something more productive before the competitors in your field do. But switching trades frequently to chase perceived better opportunities may also be a big mistake.

No specialist contractor or subcontractor can compete in more than a few areas. Trying to run several trade specialties dilutes your time, energy, resources and your ability to promote yourself successfully in each of those specialties. In short, be selective in the type of work you do. Decide what you're best at. Which jobs will put the most profit in your company bank account? There's little point in handling general construction if what you really enjoy doing is concrete work. But if you can't show a good profit pouring concrete, you'll soon become disillusioned with your efforts.

Once you've chosen your type of work carefully, marketing your company effectively becomes essential. All contractors must sell themselves. You have to learn to sell yourself and your company effectively. Good organization, scheduling, purchasing, supervision and collection are irrelevant until you've landed a contract. Only then is there a job to organize, schedule, purchase for, supervise and collect on.

Figure 10-6 shows that most construction companies have only four basic "moving parts." That's why the most straightforward method of company organization is the best. Complexity only tends to confuse everyone, especially you and your employees. The very last thing you need is overlapping departments where it's not entirely clear which department has responsibility for a particular activity. You end up with either duplication of effort or, worse still, some things falling through the cracks. There's no room for unwieldy or cumbersome organization in a small construction company.

The first part of every small construction business is the owner. He's the originator (the boss), the person with the drive, the guts and the ideas. Next comes the sales/marketing arm. Somebody has to sell the end product. Nothing happens in any construction business until somebody sells something. The sales/marketing arm of most small construction companies will be the owner. That's an extra burden on him — in addition to his responsibilities for motivation and direction.

Next on the list is the construction supervisor. He's the workhorse, the engine of the business. What you sell has to be built. Having experienced, dedicated and honest people in the engine room can help ensure your future growth.

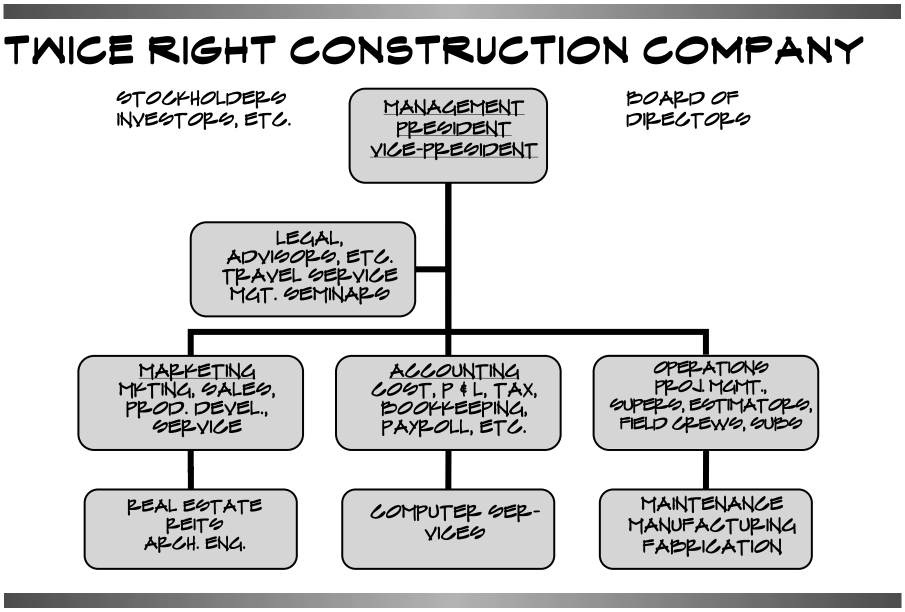
Last, but not least, is the accounting department. Someone's got to be right on top of the paperwork and the cash flow projections if your business is going to thrive.

One person can fill two, three or even four of these roles in a small company. *But if the owner wears all four hats, work seldom flows smoothly.* Some tasks will get ignored while others will receive more attention than they really need. Very few builders can handle management, sales, project supervision and accounting equally well. Ideally, even a fairly small construction business would have one person responsible for each of these four key functions.

"As the company grows, the organization will become more complex..."

Of course, many construction companies, even small ones, have more than one owner. In fact, there are many ways to slice the ownership pie. They vary from sole ownership to full employee-owned organizations. The most common form of ownership is the *Key Player* method — ownership is divided among the principles of the business in proportion to their financial or time contribution to the company, or to their seniority. For example, the founder of the company might own 51 percent of the stock, with the marketing, construction and accounting managers owning the remainder between them. This leaves the founding owner with overall control, but gives the other key players a stake in the company's future and the right to be heard on major decisions. It also provides security for the co-owners who don't have overall control.

In the early stages of its existence, a construction business might be organized as in Figure 10-6. At that stage, there may be only three full-time members of the company — all the rest of the staff being either temporary hires or subcontractors, as required. Each full-time member has a distinct function or functions, and each may have an ownership interest in the company. As the company grows, the organization will become more complex, as shown in Figure 10-7, but it retains the same basic structure.



Construction company organization
Figure 10-7

The Family-Run Company

The organization of a family-run business will be somewhat different. Family-owned and -operated businesses tend to be run like a family. And many construction companies are family-owned — maybe even a majority of them. This may be an advantage, provided it's a close-knit family. Relatives tend to be loyal, long-term employees. Each knows what to expect from the others.

However, the danger in a family-run company is that business decisions may be made for non-business reasons. In the worst case, a family member may feel that he or she has a permanent job with the company and an automatic share of the profits, even if he or she makes little or no contribution to the running of the business. This drains the energy of the other family members in the company and discourages non-family employees in the organization.

Every non-family employee has the right to resent any appearance of owner nepotism, especially in promotions. This is particularly prevalent in the second generation of the family, where the children of the owner may appear to just walk into senior positions in the organization without having to pay their dues. A wise owner who plans to bring his children into the business will start them off at the bottom. He'll see that they work in every area of the company — to get experience of how each part of the company works — before considering promoting them to a management position.

Every member of the company wants to compete for advancement on terms that he feels are fair and impartial. Having family members in senior positions is always easier if they were among the originators of the firm or if they are seen to have worked their way up through the organization. As founders or true contributors, they are more likely to be perceived as having put in their time and to have earned the right to their management position.

Summary

Define and set annual and lifetime goals. Begin now to prepare for retirement. Take some time to prepare a personal Finance, Goal and Time Projections chart, as in Figure 10-4. Develop a clear idea of the type of company you're building and where you're going with your business. Select your construction specialty and stick to it. Remember, every small construction company is like a stool with four legs — the owner, the marketing manager, the construction manager and the accounting manager. Weakness in any one leg can affect the whole company and could, topple it over.

Plan your company structure as it grows; don't just let it happen haphazardly. Avoid any appearance of nepotism at all costs as it can be very destructive to the morale of an organization. It can result in you losing good people who are not family members, if they sense that their chances of promotion in the organization are always going to be thwarted by a family member.

Go Where the Money Is

It takes three things to thrive in construction — generating solid profits, avoiding damaging errors and successfully dealing with declining markets.

Every builder has to learn to move assets and shift emphasis in sync with the economic cycle. A profitable builder understands his market and anticipates the economic cycle. He sees opportunities, and changes as they change. He relies on a competent team of professionals (architects, engineers, supervisors, tradesmen and realtors) who know their business and have the essential skills needed to succeed in their jobs.

Don't think of yourself as just a home or apartment builder, office builder, restaurant builder, remodeler or whatever. All building markets slow down from time to time. Be versatile, but stay within your area of competence, and plan to be where the money is, in the *early* part of the economic cycle.

Most builders make money in good times. It's the bad times that separate successful builders from the herd. To thrive in the next building boom, you have to find a bridge over the abyss of a declining market.

In the good times, don't spend too lavishly. That's the time to build your reserves. And avoid deals where everyone will lose if the economic cycle turns downwards before it was anticipated. Remember that costs are likely to overrun more, not less, as you work through a job. There's usually no way out of a bad deal once it's been made. So, avoid making it in the first place. When work gets scarce and construction is heading into the tank, listen to your professional team, not to your ego.

Also realize that lots of spec projects take well over a year to complete, so you have to think ahead to anticipate what the state of the market will be when your project is coming to completion. It's not just a question of how good the market is when you get started, but what it's going to be like when you finish the job. That's when you'll be trying to rent the space in your office block, so that's when you'll need the office leasing market to be good — not when you start the project.

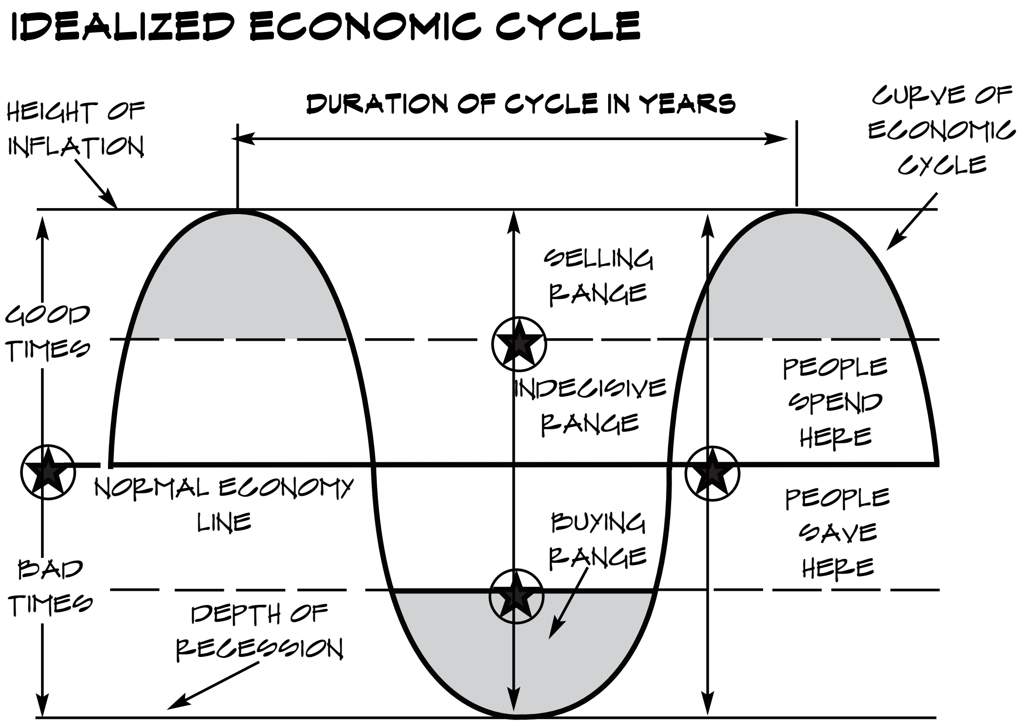
What Goes Up May Not Come Down

Every contractor has to deal with inflation. Think of inflation as erosion in the value of money. By itself, it's neither good nor bad. It just makes things different. It's like a new deal of the cards in a poker game. Some players come out better and some come out worse. If you're on the wrong side of inflation, you lose as surely as if someone had cut a hole in your wallet. But catch the inflation wave just right and your assets increase in value much faster than the value of the dollar erodes.

A period of inflation tends to accelerate the pace of construction, because owners of hard assets win out as the dollar loses value. That makes inflation a real temptation for builders. Some get greedy. They want to buy or build everything in sight. But inflationary acceleration never lasts forever. As the acceleration eventually stalls, the subsequent deceleration crushes those who started building at the wrong time in the economic cycle or who couldn't get out of the way in time.

Don't put all of your eggs in one basket, even during strong inflationary periods. Avoid massive speculation, even when increasing inflation is clearly on the horizon. *Be satisfied with controlled growth.* Expand with systematic buying and building. Then plan on a period of settling-in and consolidation. Get comfortable with what you already own before expanding further. Keep some assets and borrowing power in reserve, even when inflation is accelerating. Never commit all your assets to a single make-or-break deal.

Try to anticipate the market, not just react to it. Remember that the construction industry follows a roughly five-year cycle. Look at Figure 11-1 (we looked at this figure previously in Chapter 5). Remember that we have one period of buying, one period of selling and two periods of consolidation per cycle. Try to have the properties you need to position yourself in the seller's market at the height of the inflationary curve. The best way to do this is to buy land and property in need of remodeling during the buying range at the depth of the recession. Of course, this takes cash and foresight. I'll talk a little later about how to amass the cash reserves you need. But you'll have to supply the foresight. It's not that hard if you pay close attention to the leading economic indicators. Read the business section of your newspaper and one or two good business magazines. Listen to the financial news



Buying, selling and consolidation
Figure 11-1

channels on cable TV. There's plenty of financial information available — perhaps too much — but you'll still have to make your own decisions.

Any builder who ignores the economic cycles is going to have trouble. Building the same number of spec homes year after year is a recipe for disaster. Your market's volatile. If you're supplying a fixed quantity of product to a volatile market, that leaves precious little margin for error.

The Multiplier

Inflation is the multiplier. It's so utterly simple that most people either don't understand it or they overlook it. Here's the *Rule of Multiplication* — it's not what you own that counts so much as how many of them you own.

Look carefully at Figure 11-2. Notice that there are two multipliers at work here. One is the length of time you hold a property. The second is the number of properties you hold at a given time. The most important multiplier is the quantity multiplier, which is the number of properties you own or the total value of those properties. Without it, the time element doesn't

THE INFLATION MULTIPLIER

YEARS OF OWNERSHIP AT 5% INFLATION

NUMBER OF PROPERTIES OWNED

	ORIGINAL INVESTMENT	1	2	3	4	5	6	7	8	8	10	TOTAL PROFIT
1	$100,000	$105,000	$110,250	$115,763	$121,551	$127,628	$134,010	$140,710	$147,746	$155,133	$162,889	$62,889
2	$200,000	$210,000	$220,500	$231,525	$243,101	$255,256	$268,019	$281,420	$295,491	$310,266	$325,779	$125,779
3	$300,000	$315,000	$330,750	$347,288	$364,652	$382,884	$402,029	$422,130	$443,237	$465,398	$488,668	$188,668
4	$400,000	$420,000	$441,000	$463,050	$486,203	$510,513	$536,038	$562,840	$590,982	$620,531	$651,558	$251,558
5	$500,000	$525,000	$551,250	$578,813	$607,753	$638,141	$670,048	$703,550	$738,728	$775,664	$814,447	$314,447
6	$600,000	$630,000	$661,500	$694,575	$729,304	$765,769	$804,057	$844,260	$886,473	$930,797	$977,337	$377,337
7	$700,000	$735,000	$771,750	$810,338	$850,854	$893,397	$938,067	$984,970	$1,034,219	$1,085,930	$1,140,226	$440,226
8	$800,000	$840,000	$882,000	$926,100	$972,405	$1,021,025	$1,072,077	$1,125,680	$1,181,964	$1,241,063	$1,303,116	$503,116
9	$900,000	$945,000	$992,250	$1,041,863	$1,093,956	$1,148,653	$1,206,086	$1,266,390	$1,329,710	$1,396,195	$1,466,005	$566,005
10	$1,000,000	$1,050,000	$1,102,500	$1,157,625	$1,215,506	$1,276,282	$1,340,096	$1,407,100	$1,477,455	$1,551,328	$1,628,895	$628,895

NOTE: We've used $100,000 as the average price of a property, which will be quite unrealistic in many areas of the country. However, it's a very easy number to multiply by whatever figure is appropriate, 2, 3, 4 or even 5 on the West Coast to come up with the average price of a home in your area.

Inflation multiplier
Figure 11-2

matter much. You can hold 20 houses (at $200,000 each) for a year and make $200,000 profit. But if you have no houses for five years, you'll come out with nothing.

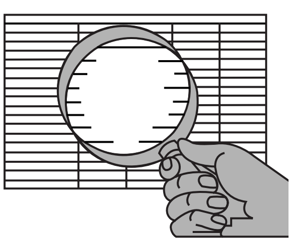
Let's do an example using Figure 11-2. If you buy four houses (at $150,000 each), for a total of $600,000 and hold them for eight years, the total value at the end of the eight years would be $886,473 (see shaded box). This is a profit of $286,473 ($886,473 minus the $600,000 you paid for the houses) over an eight-year period. But you probably only made a 20 percent down payment on each house, so your out-of-pocket expense for the four houses was just $120,000. If you take the profit of $286,473 and divide it by your original outlay, your gross eight-year profit is a whopping 239 percent. To find your annual return, just divide $286,473 by eight years, giving you an annual profit of $35,809. Now divide that by your original investment of $120,000. You made a 29.8 percent annual return. Almost 30 percent — not a bad deal at all.

However, it isn't quite as simple as that. Remember, you only made a 20 percent down payment on those four houses, so where did the other 80 percent (i.e. $480,000) come from? A loan or loans, of course. And those loans had to be serviced. Rather than calculate what the loan payments would be and how they would eat into your annual return, let's make the assumption that each property was in rentable condition or that you quickly remodeled it so that it could be rented. Then the rent you received would probably be just about sufficient to cover the loan payments, property taxes and maintenance costs. This is a fairly rough assumption, but it's generally not far from reality. So, in fact, you did get an annual return close to the 30 percent we just calculated, assuming that your remodeling costs came out of the loan amount. And, of course, since the properties are investments that can be depreciated over time up to a total value of $1,000,000, there's an added advantage at tax time.

Housing prices, on average, have doubled every five to seven years in the last 40 years. Therefore, to become a millionaire, all you had to do was buy 16 $100,000-priced properties with 20 percent down and rent them for at least 10 years. Then sell. The profit would have been over $1,000,000 (2 x $503,116 in the right-hand shaded box). Of course, 16 properties is a significant investment, but purchased at two or three per year, it's surprising how quickly that number can be reached.

Owning property and developing land has been among the best investments over the last 40 years. You should have a piece of this action. Here's how — hold onto 10 percent of what you build to get the full advantage of inflation. So if you build 10 houses, sell nine of them, but keep one for your inflation multiplier and rent it out to cover the loan payments and property taxes. Take advantage of inflation by becoming a property owner, not just a spec builder. It's important to make this distinction. Simply stated, thriving begins with the multiplier, that is, ownership. Own some of what you build and ride the crest of the inflation wave. That's smart construction.

Many contractors have made a good living building spec homes over the last 40 years. But generally, the buyers of those homes have done even better. They usually resold the property a few years later and made several times what the builder originally made. And it took very little risk, effort or investment on their part. It's the property owner that has the advantage in the inflation game.



Look at Figure 11-3. Notice that the owner out-earns the builder by a wide margin in the Total Earned column. And, after only a couple of years, he's ahead in monies earned ($20,500 vs. $20,000) even at a fairly low inflation rate of 5 percent. But the builder-as-owner does even better, with a grand total of $145,779 after 10 years. And this doesn't even take into account tax considerations, interest write-offs and depreciation.

There's an additional advantage to ownership. Let's say you make a 10 percent profit on the construction of a $500,000 commercial property or apartment building. That's $50,000. Normally you would have to pay about $12,500 tax on that profit.

BUYER'S VERSUS OWNER'S PROFITS

Property owner	Starting value	Builder's 10% profit	# of ownership years at 5% inflation rate										Total earned
			1	2	3	4	5	6	7	8	9	10	
Builder - sells property to owner *	$200,000	$20,000	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$20,000
Owner - buys property from builder	$200,000	$0	$10,000	$10,500	$11,025	$11,576	$12,155	$12,763	$13,401	$14,071	$14,775	$15,513	$125,779
Builder retains property *	$200,000	$20,000	$10,000	$10,500	$11,025	$11,576	$12,155	$12,763	$13,401	$14,071	$14,775	$15,513	$145,779

* Does not include tax and interest write-offs, depreciation or cash flow from the actual construction work or rental income, etc.

Buyer's versus owner's profits
Figure 11-3

But, suppose you take a $50,000 ownership interest in the property instead of taking the profit. As a co-owner, you can deduct depreciation and interest charges from your taxable income, offsetting that $50,000 profit and reducing your tax proportionately.

If you hold a 10 percent interest in much of what you build, you're in the multiplication business. But avoid unnecessary debt like the plague. Just remember, building is great, but multipliers are even better.

Their Buck vs. Your Buck

Some economists have suggested that access to credit is the foundation of most wealth. You probably can name several people who made their fortunes with OPM — Other People's Money. It happens all the time. To understand this principle, you need look no further than your own income and the source of most construction money. First, let's look at your income. If you're like most builders, your personal income is between $50,000 and $150,000 a year. Your living expenses probably are between 50 and 110 percent of your after-tax income.

If you have an annual income after taxes of $100,000 and living expenses of 50 percent, you can't possibly accumulate more than $50,000 a year in savings and investments. Ten years of accumulations are needed to have enough cash to build a small commercial building. Three years of accumulations would build a reasonably-sized house in some areas of the country. At that rate, you could build less than half a dozen small commercial buildings in your working lifetime. Building for cash, without loans, is prohibitively slow.

The only alternative is borrowing. Thus, by default, we enter the realm of OPM, which brings us to banks and bankers.

Banks and Bankers

The real function of a bank is to pile up one group of people's money in convenient stacks so that other people can come in and borrow it. For this service, the bank charges fees which also seem to pile up quickly, depending upon the going rate of interest. In recent years, the interest rates on loans have been at historic lows, but the Federal Reserve is now making moves to bring interest rates back up to a more normal range.

Any institution or anyone that accumulates money and loans it out again is acting as a bank. The U.S. Government, Bank of America, insurance companies, pension funds, private investors, your employer, your partners, your friends, parents and your spouse's nest egg are all banks, in a manner of speaking. No matter who the lender is or how much is borrowed, the principle is the same. Almost everyone in business uses other people's money. This is especially true of the construction business because construction is so material-intensive. Banks spend the bulk of their time collecting money from depositors who come through the door of the bank. They pay depositors three to seven percent interest and collect 10-15 percent on loans — all with very little risk because of the collateral required of borrowers in return for the loans.

As you can see, banks are just middlemen. It makes you wonder if there's any way to bypass the middleman and save the middleman's fee. Could you stand at the front door of the bank and intercept depositors before they can get to a teller's window? Could you offer potential depositors higher returns and the safety of a bank if they invest their money directly with you?

In practice, the answer is no. You can't offer depositors all the bank services they expect. And, you especially can't provide the insurance on their deposits that the bank is able to offer through being a member of the FDIC, the Federal Deposit Insurance Corporation. The FDIC covers each deposit account up to a maximum of $100,000, in the event that the bank goes belly up. But don't give up too soon. Some large depositors may find your offer very appealing. And, they may have a pile of money large enough to be useful to you. Remember, they're only getting three to seven percent on their bank deposits.

Believe it or not, it's quite possible for you to arrange your life and business affairs so you can work exclusively with private investor money, thereby eliminating one of your major debt partners — the banking institution.

Some builders have learned to work without banks at all, at least for loans. Not only is it possible, it's desirable. Remember, banks don't like to be flexible. They want regular loan payments on a specific date each month, whether or not you've collected your receivables or made a profit.

A private investor is less likely to be over-concerned about regular monthly payments, and may be willing to adjust payments based on the progress of the project.

Though handling private investors has its own special problems, the greater flexibility more than offsets any difficulties. Of course, you're not going to persuade a private investor to entrust his hard-earned money with you until you've established a good reputation. So, it will take some time, but it's one of the things to be on the lookout for as soon as you've gotten your business reasonably well established.

The Limited Partnership

For the builder who's reluctant to borrow or can't borrow from the bank as much as he needs, the limited partnership (LP) is a good alternative (either for part or all of the funds he needs). Limited partnerships deserve careful consideration from every speculative builder. I'll cover the high points here and outline some of the ways you can get in trouble, so you can avoid them.

Understand first that limited partnerships have a bad reputation with some investors and in some parts of the country. LPs have often been used to swindle investors and to avoid paying both state and federal taxes. But don't let that discourage you. It isn't the form of organization that's bad, it's the people involved. If you've got a good project that can succeed on its own, bringing it to the world in the form of a limited partnership won't do any harm.

But, because limited partnerships have been abused so often in the past, virtually all states (and the federal government) have passed, or are considering, legislation that would control LP formation or change how they're taxed. Know what the current laws in your state require before going too far with your LP plans, and be aware of the possibility of future legislation that might affect them.

Tax Advantages of Limited Partnerships

Limited partnerships are like corporations in some ways. Limited partners are investors, just like stockholders. They have no day-to-day voice in running the company and aren't liable for the company's debts beyond the amount of their own specific investment. The general partner runs the project and will be liable for the partnership's debts. But limited partners have one big advantage over stockholders. Stockholders are taxed on dividends received, not on corporate profits. If the corporation loses money, none of those losses show up on the stockholder's tax return (until the stock is sold or becomes worthless).

Not so for limited partners. The partnership pays no taxes. Instead, all gains and losses flow through to the limited partners. That's a big advantage if the partnership can be expected to show losses (from depreciation) in the early years of its life. Of course, limited partners hope to make profits, eventually. But when profits finally begin to flow, they may qualify for the lower tax rate that applies to capital gains.

"Potential investors may be prohibited from buying into the partnership if they don't meet certain financial requirements."

Because the tax advantages of limited partnerships are so significant, they have been both used and abused frequently. Today, all states set restrictions on how limited partnerships must be formed. If your partnership has more than a certain number of investors, special disclosure requirements must be met. You may not solicit more than a handful of potential investors. The participants should be friends or close business associates, perhaps even family members. Potential investors may be prohibited from buying into the partnership if they don't meet certain financial requirements. For example, net assets (exclusive of a home) must exceed a certain amount, and annual income may have to be above a certain level. Be sure to keep a current personal financial statement on file for each investor. State inspectors might ask to see them one day.

Of course, you can't advertise publicly for investors. Remember, you're supposed to know these people before they became investors. However, in many cases, this is only half true. News of attractive investment opportunities travels like greased lightning. Many partnerships are composed of people who become friends and business associates only while the limited partnership is being formed. But, no matter where you find your partners, the fact remains that you can't advertise for them. Doing so constitutes a public offering and is subject to the rules and regulations of the SEC, the Securities and Exchange Commission, and the state Department of Real Estate. You don't want to get mixed up with them.

Get Good Professional Advice

If you're considering a limited partnership to raise capital for real estate development, for heaven's sake, get good professional legal and financial advice. Nearly every metropolitan area has attorneys and accountants who specialize in the formation of limited partnerships. They'll be invaluable to you and your partnership's success.

The Prospectus

Limited partnerships are sold with a prospectus that outlines the purpose of the partnership, the money to be raised and its use. The prospectus lists the general partners' names, addresses and their qualifications to handle something like the project being considered.

The purpose of a prospectus is to disclose everything potential investors should know. If you leave some important information out of the prospectus you're certain to be involved in a lawsuit if anything goes wrong or if the investors don't make as much money as they expected.

Distribution of the prospectus will usually be limited to about 25 copies. You can show it to only 25 potential investors. And generally only 10 investors will be allowed to participate.

"The prospectus is designed to disclose to potential investors that their money is going into a risky deal that may go sour."

Nearly every prospectus will be similar in many respects. The first few pages will have general information about the people involved, the property itself, the building(s) to be constructed and so on. It will also include a cash flow and expense breakdown for the life of the project, usually five to 10 years. After that time, most of the heavy deductions will have been used up and the partnership will be sold.

The next part of the prospectus will outline the ownership percentages — who gets what and when — how profits and losses are to be divided. This is extremely important. Many times all the tax deductions are passed on to the investors as an added incentive for them to get into the deal, even if they don't own the whole partnership between them. Deductions, profits and losses are not necessarily divided rigidly, point for point, to the percentage of ownership. But make sure this is in your prospectus. If it isn't, the courts will devise a distribution plan, one that will displease at least some of the limited partners.

Somewhere near the front of the prospectus there'll be warnings about how the whole thing may collapse. You know that old saying, "*Buyer Beware.*" Every prospectus has plenty of that language.

If your project loses money and the investors get wiped out, that's unfortunate. But as long as the correct warnings were in the prospectus, you're in the clear. In practice, some promoters steal from their investors and get away with it because the prospectus explained that they were thieves and it disclosed that they planned to run off with everything that wasn't screwed down. It won't be spelled out quite that clearly, of course, but it's perfectly legal if the investors gave their consent on the dotted line.

The prospectus is designed to disclose to potential investors that their money is going into a risky deal that may go sour. If it does, they'll lose their investment. Language like that helps remove the responsibility for losses from the backs of the promoters and may help them win the ensuing lawsuit in the event that the deal goes belly up.

Your prospectus will include two more sections — the actual limited partnership agreement and a blank personal financial statement to be filled out by each potential investor.

Limited Partnership Agreement

The limited partnership agreement is almost always written by an attorney. You and your accountant can write the other parts of the prospectus. But the actual partnership agreement has all the legalese that only attorneys and judges understand, so leave it to your attorney.

The partnership agreement says who will keep records, file tax returns, where the business will be conducted, how general partners are removed, how the sale of partnerships is to be handled and how profits and losses will be divided among the partners. In short, it's the basic document that describes all the rights and responsibilities of the partners. Boring, but necessary.


Limited Partnership Agreement

Agreement of

Adopted By

Here's another point to ponder. One or more of the promoters will usually be the general partner (GP). The GP usually has an interest subordinate to that of the limited partners. In other words, general partners should participate in the profits only after all limited partners have received distributions equal to their original investment, plus interest at a specified rate. Only after all of these payments have been made should the general partner(s) take their share of the profits.

Limited partners consider this an added incentive that guarantees the general partner's best efforts. Limited partners also hold an interest in the land as collateral. If the project fails, the land can often be sold to recoup at least 75 percent of their original investment. The land should be recorded in the name of the limited partnership as developer, not in the name of the contractor.

Running a limited partnership is simple. The general partners do *everything* except put up the money — the limited partners do *nothing* but put up the money.

Words of Caution

Here are a few words of caution before we leave the subject of limited partnerships. No commissions may be paid to salesmen for getting investors to join the partnership and, generally, the offering may be made in only one state. But partners can move to other states after buying into the partnership, and fees may be paid to the seller for other services rendered, other than commissions. General partners should do the selling, not hired professional salesmen.

Here's another note of caution. The general partners are responsible and liable for the well-being of the partnership and the investors' funds. However, just because a limited partner is described in the agreement as a limited partner, it doesn't mean that he or she isn't actually a general partner. The distinction between limited and general partner can change without the titles having to be rewritten in the agreement. All that has to happen is for a limited or general partner to assume the role or duties of the other. If a limited partner begins to take on the activities of a general partner, then he or she may, in fact, become a general partner and have a general partner's responsibilities. A general partner may also become a limited partner by ceasing to act as a general partner and assuming the role of limited partner. But this probably won't relieve him or her of a general partner's liability or compensation.

The biggest danger in using limited partnerships to raise building capital is a stampede of unhappy, uninformed investors who want out quickly when the project begins to run into problems. A limited partnership isn't like a bank. Funds aren't available for withdrawal on short notice. Neither is a limited partner's interest like a publicly-traded stock. There may be no market for a limited partner's share. This means that, in a forced sale, the present value of a limited partner's share may be nearly zero.

Maintaining a Limited Partnership

It takes a good, people-oriented diplomat to keep limited partners content. Not every contractor has the time, talent or interest to do that. Are you willing to sit through countless meetings and phone calls with your investors? It may take several formal and informal meetings a year to keep your partners content. It's a lot like herding cattle — a minute of distraction or inattentiveness and they're all off in different directions.

Your partnership will have to survive recessions, setbacks and bad judgment. You'll need cash reserves in the beginning to ride out the unexpected. Don't think you can go back to the limited partners for additional money after the partnership has been formed and recorded. It does happen in some cases, but don't count on your investors being prepared to fund a second round of financing. If more capital is needed, the general partner is usually forced to sell some of his own interest in the project.

Finally, remember that limited partnerships are business transactions, not your personal piggybank. Successful contractors who use limited partnerships protect their track record. They want a string of good deals with satisfied partners spreading the word. A few bad deals that end in lawsuits can put any builder out of the limited partnership business — permanently.

From any perspective, if you're in the construction business, you have to work with someone else's money. It's a way of life for almost every builder. But the way construction projects are bankrolled is always changing. As it does, you should change with it.

Try hard to avoid using your own money on projects that involve partners or that you are doing for other people. Invest your own money in your own projects that are built for your own account exclusively. Don't get partners involved in these projects. This cuts your money risks to a minimum. *Always isolate your own money from risk wherever possible.* When any significant risk is present, work on their buck, not yours.

Cash Is King

Thriving in the construction business requires cash. Builders who have some cash will survive. Those who have even more cash will thrive. Those who have a lot of cash can retire, take trips and count their money. But no matter how you cut it, *Cash is King*.

There's no substitute for free cash reserves. That doesn't include borrowed money or the ability to borrow. Nor does it include the equity in your house, car, boat, equipment or business inventory. It also doesn't include mortgages or second trust deeds — only if you sell the asset you've borrowed against. Liquid instruments like stocks, bonds and commodities are cash reserves if there's an immediate market for them. But when the market changes, so does their value.

"With cash on hand, you'll be able to take advantage of equipment and material discounts."

The only real cash reserves are cash, gold, silver, or other assets that are immediately saleable at a good price, regardless of the economic circumstances at the time of liquidation. If you plan on thriving in the construction business, start building real cash reserves. Believe me, you'll sleep better at night.

Without cash reserves, everything is a struggle. Buying on credit is always more expensive. Credit transactions increase the seller's cost and carry the risk of non-payment, so every seller has to sell at a somewhat higher price when he sells on credit. The cash buyer should, and usually does, get the lowest price. But you may have to ask for it; don't expect it to be handed to you automatically.

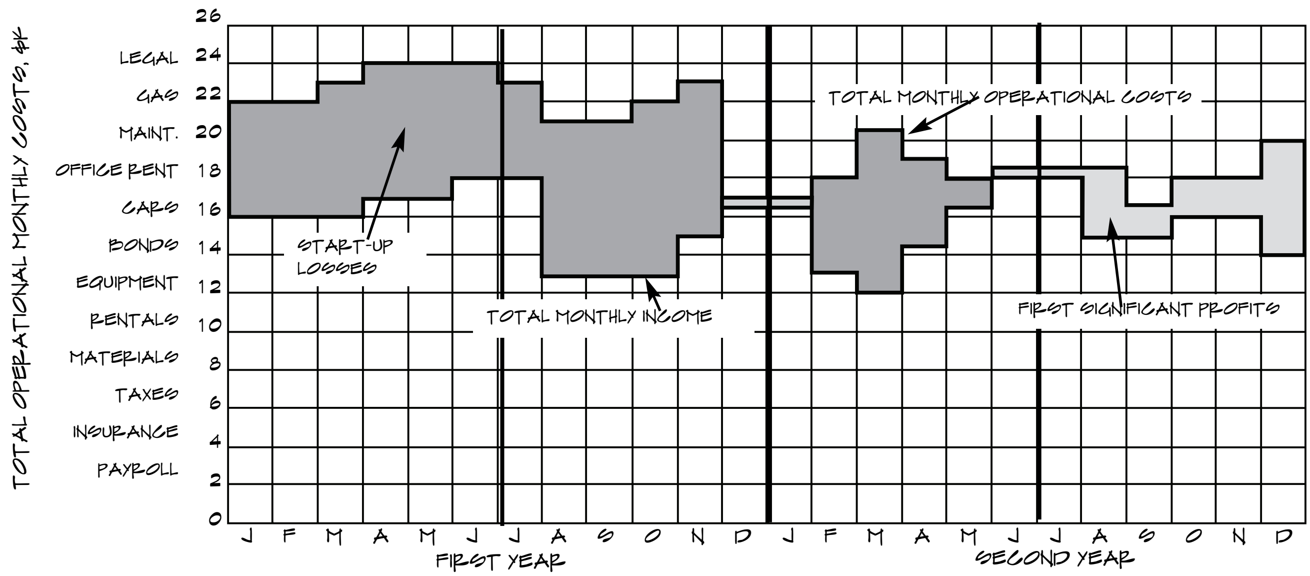
With cash on hand, you'll be able to take advantage of equipment and material discounts. That lowers your job costs and increases your profit margin with no additional effort. These savings are like found money.

There's a point of diminishing returns, however, for cash reserves. As the cost of what you're buying increases, the percentage of cash reserves needed to complete that purchase also increases. And there's a point at which tax considerations become important.

Cash on hand should equal 10 percent of your total bonding capacity. For example, if your bonding capacity is $1,000,000, you should have $100,000 in reserve. This doesn't include equity in real estate. It can be in certificates of deposit, pension or insurance funds or anything else that's reasonably liquid.

Unfortunately, most builders can't keep 10 percent cash in reserve. Many builders never even come close. Maybe that's why about 50 percent of builders fail in the first few years of business and many of the rest are barely profitable or are actually unprofitable.

START-UP PROFITS AND LOSSES



Start-up profits and losses
Figure 11-4

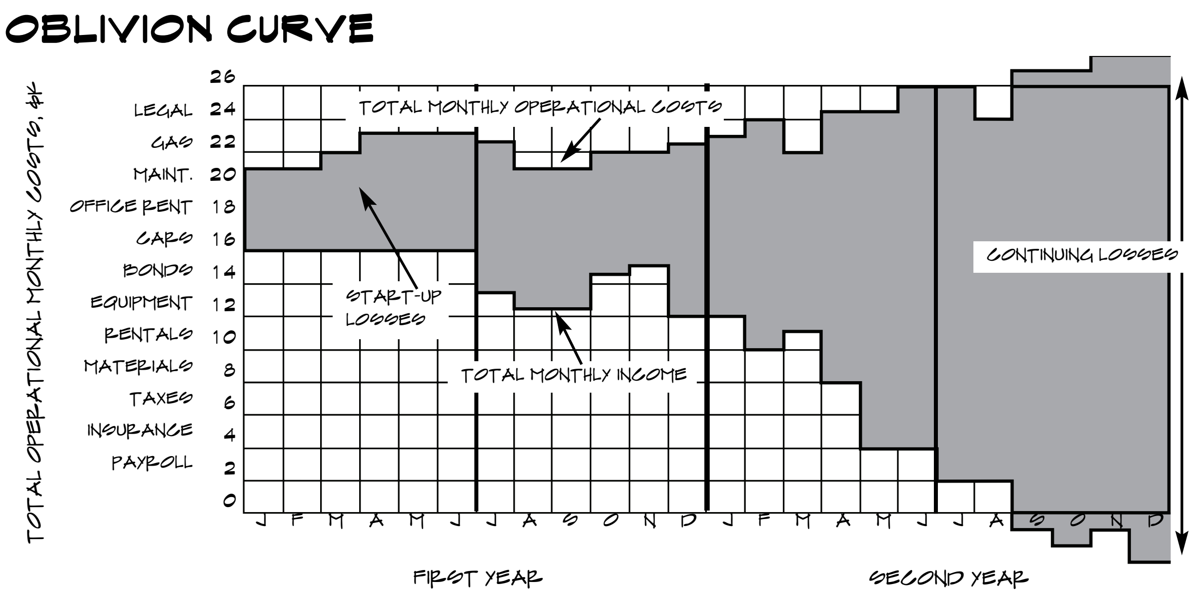
It's common for builders to struggle along with five percent or less in cash, snowing their bonding company by floating unrecorded personal loans that look like cash reserves. Few bond underwriters dig deeply enough to uncover this kind of deception. Some would rather ignore it because bonding companies only make money when they write policies. So, after a cursory investigation, a signed affidavit of solvency and an updated financial statement, it's voila — one construction bond coming up.

Staying Power and Reserves

Your staying power describes how long you can hang in there as a builder when others are leaving the industry. It's determined by your cash reserves, liquidity and debt-to-equity ratio.

Essentially, every business starts with a loss. That's because going into business costs money: to pay for a phone, office equipment, stationery, the first week's payroll, etc. This money has to come from savings, sold assets or borrowing.

The darkly shaded area between the Total Monthly Operational Costs (Cost) and the Total Monthly Income (Income) lines in Figure 11-4 is the amount of money needed to carry the business during this start-up period.



Oblivion curve
Figure 11-5

Hopefully, the Cost line drops with time and the Income line rises to meet and eventually exceed it. The point where the two lines intersect is the break-even point. As Income rises above Cost, you bank your first real profits. That's your first opportunity to set aside some cash reserves.

The magic moment in every business is when, through skillful management and cost control, assets actually begin to exceed debts. It's tough for most builders to get there. Some never actually manage to make it. If you do make it, don't blow it immediately by taking on new debt. Ignore the urge to buy the latest luxury car or a new tractor. Salt the cash away. Someday you'll need that money in reserve.

Unfortunately, too many contractors follow the performance curve in Figure 11-5. I call this the "Oblivion Curve." This builder started with the same business outlook as the builder in Figure 11-4. But poor management skills, inexperience, lack of sales ability and excessive debt never allowed him to get Income ahead of Costs, and sent him nose first into the Oblivion Curve. There's very little hope of recovery here, short of bankruptcy.

A new construction contractor should be ready to supply between 10 and 20 percent of his operating costs from his personal funds for the first 12 to 24 months that he's in business. Another rule of thumb is that a construction business won't be profitable for the first 12 months, but should become profitable sometime between 12 and 24 months of operation.

Here's another guide for cash-planning in a new contracting business. Debts of the new business shouldn't exceed profits until the cash reserve is equal to 10 percent of bonding capacity. Even then, debt shouldn't exceed annual profits and 10 percent of bonding capacity combined. Eventually, debt load should decline. When it does, you're beginning to accumulate assets that can multiply with little effort.

Summary

Inflation can make or break you. It's a matter of timing. Take time to study the economic cycle shown in Figure 11-1. You can make inflation work for you. Remember, quantity is the important multiplier. It's not really a question of what you own, but rather how much of it you own. Retain ownership to 10 percent of what you build and let inflation work its magic.

Work with the other guy's money, not your own, especially when there's any significant risk in the project. If possible, work with investors' money and forget about banks. Try to generate enough cash to carry some projects on your own without using partners.

Remember, cash is king. Try to keep 10 percent of your bonding capacity available in cash or liquid assets at all times. Use anything in excess of that 10 percent for material and equipment purchases. But don't dig into that 10 percent — that's your reserve.

Over-Design, Under-Design and No Design

So far, we've spent a lot of time on the nuts and bolts of the construction business, but there's a lot more to building than just construction. There's a considerable amount of work that has to be done before there's anything for you to actually build. A lot of this work involves architects, engineers and watch dog agencies.

Dealing with design professionals (architects and engineers) and government bodies is a very important part of construction contracting and land development. Most successful builders spend a lot of time working with design professionals and government agencies. In fact, the more successful you are, the more time you'll have to spend in architectural and engineering offices and with government personnel. If you presently feel more comfortable driving nails and bidding jobs than negotiating with architects and commissioners but are eager to change that, this chapter should be very helpful to you.

Architects and Engineers

Everything you construct should be built using professional-quality plans. Fortunately, most architectural and engineering firms prepare adequate construction plans and specifications. On some jobs, the plans may have gone through the plan approval process and been finalized well before you ever see a set of prints. You, as the builder, may have little influence on the design of the final product. Your only responsibility may be to execute the design as conceived by the owner and drawn up by his architect and engineer. However, on some other projects, you may get the opportunity to help select the design staff and even participate in the design process. And you most certainly will if the money you're spending is coming out of your own pocket.

Most builders have discovered that architects and engineers don't think like builders. They don't foresee many of the construction problems created in the plans they draw. Because architects neither pay for, nor build, what they design, they don't have to be especially practical. They're in the aesthetics business, not the construction business. You may have heard of the infamous case of the Sydney Opera House. The original architectural design that won the international competition was deemed impossible to build, other than by casting an enormous block of concrete and carving the building out of it — hardly a very practical technique!

By comparison, engineers tend to focus on what will do the job and what won't. An engineer's primary goal is to find a design adequate for the intended purpose, getting you from where you are to where you want to be as directly as possible. He also has to ensure that the building will be safe and will last for the intended life span. In short, the engineer will get you from point A to point B, while the architect is concerned about the quality of the journey.

The architect also wants to get you there, but his goal is to get you there with the best possible aesthetic result. Quality of the end result is what's important to him — not how quickly and economically it can be completed. Architects create the concept for a project; the engineer tries to make it practical and possible to build at a reasonable cost.

Engineers are nuts and bolts people. They work with strengths, loads and capacities — drainage, grading, streets, walls, floors, roofs, dams, water systems, sewage disposal, bridges, power distribution and air-conditioning systems. The engineer's seal on the plans is his certification that the design meets the applicable building codes.

The Design Process

In order of creation, the owner begins the design process with a perceived need. The architect proposes a form of building that will meet that need and frequently his own aesthetic desires. The engineer finds a way to make the architect's concept meet load and strength standards. Finally, you, the builder, must find a way to turn that design into a building. This is the traditional pecking order in the construction industry.

On some projects you may have the luxury of selecting your own architect, especially if you're putting up the money. Some construction companies either have an architect on staff or have established working relationships with one or two architectural firms. If you're selecting an architect for the first time, interview several in your area who handle the type of projects you want to build. Over lunch, do a little brain picking. Find out what sort of projects they've designed and how they approach their projects. Ask how their office is organized. What's their specialty? Who's on the staff? Find out how they get work and what they charge for their services. Within an hour, you'll know if their approach fits well with yours.

"The best and easiest time to achieve cost control is when your project is still on the drawing board."

Integral to your selection of a qualified architectural or engineering firm will be their ability to work with you and to have a mutual respect for each others' capabilities. Remember, the street should run in both directions. You'll send business their way and they should be willing to refer business to you when the opportunity arises. You may want to work with more than one architectural firm — a small firm for small jobs, a larger firm for larger jobs.

Don't be afraid to inquire about fees. That's an important part of your investigation. There are recommended fee schedules for both architects and engineers, but the fee is always negotiable. Smaller architectural and engineering firms are less likely to follow recommended fee structures, as they're trying to attract business and expand their companies. A large firm may charge more than the normal fee on a complex project.

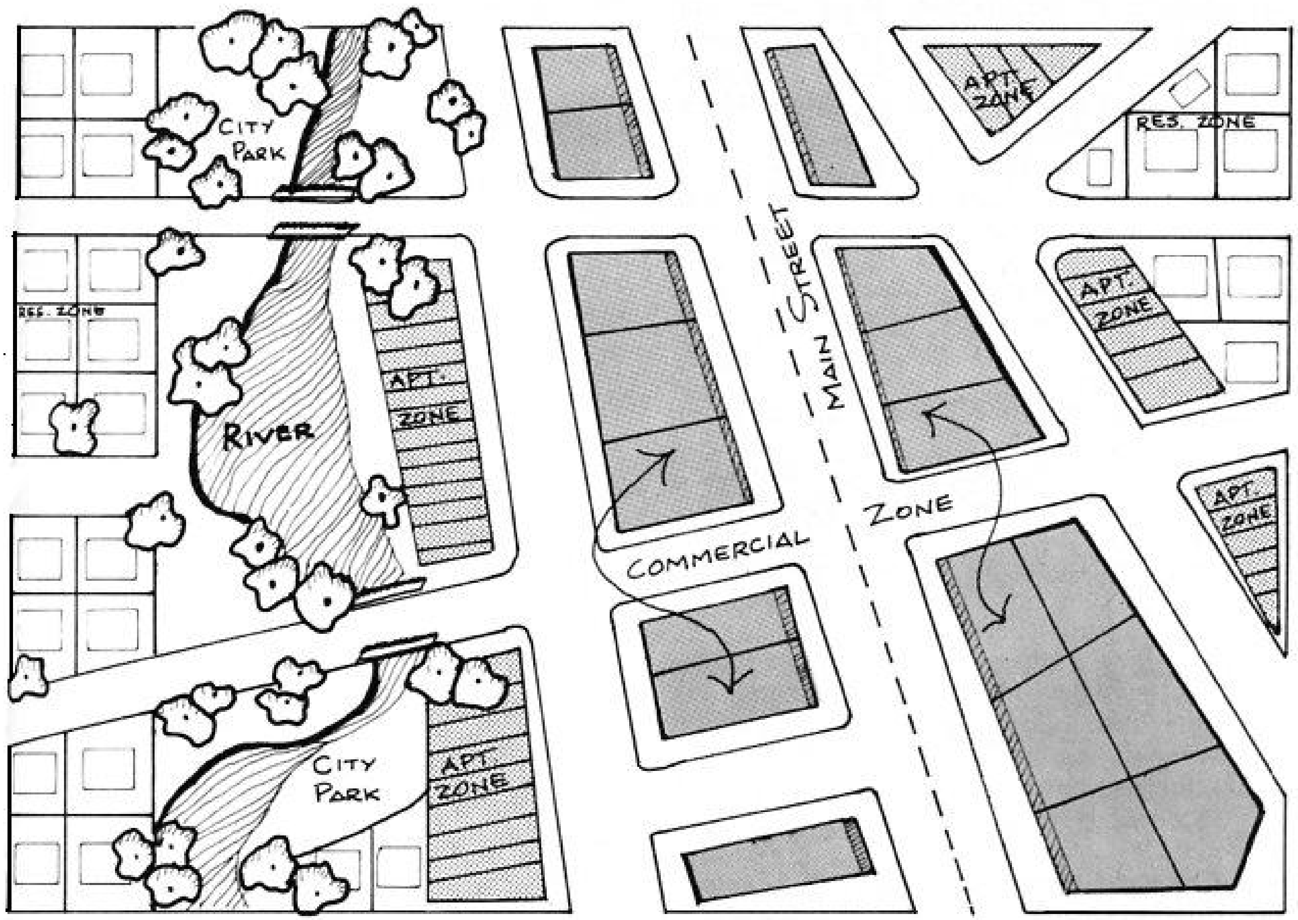
Fee schedules are based on the estimated cost of construction or the design work involved. The higher the construction cost, the more the architect earns.

Never assume that an architectural or engineering firm will protect your financial interests, even if you're the one paying their fees. Like you, they may be deeply involved in your building's design, engineering and construction. But their perspective is different. Even an architect on your payroll needs some close supervision to keep the construction cost and schedule from getting completely out of hand.

When you can participate in the initial design process, watch the work carefully. Review the architect's plans and details as they're being committed to paper. Most excessive costs in a project arise during the planning and design stages, not in the construction. The best and easiest time to achieve cost control is when your project is still on the drawing board.

Zoning and Permits

Getting any necessary zoning changes and permits can be a real pain for the inexperienced contractor. The best advice I've heard is to find which way the grain is running in City Hall and then try to run with it, rather than against it. Conform to the city and county master plans whenever possible.



City master plan (partial view)
Figure 12-1

Swimming with the current is always a lot easier than swimming against it. Nearly all cities and counties have a master zoning plan. Get a copy and review it carefully with your client, architect, engineer and attorney before even considering a request for a variance.

Most master plans have many points in common. In general, housing is clustered in one part of town and industry in another. Between these two sections falls everything else — stores, office buildings and apartments.

Look at Figure 12-1. Notice that office and apartment buildings are used as buffers between shopping or industrial centers and residential areas, and waterfront areas are used for parks and public recreation purposes.

Don't try to get a permit to build a commercial building in a residential zone. The plan was prepared by college-trained professionals who take their work very seriously. The commission that adopted the plan is not going to look with favor on any significant change in what it perceives to be a good plan. They'll spot gross incompatibility like a skunk at an ice cream social.

Here's a capsule summary of my advice on rezoning and zone variances. Don't even bother to ask, unless there's a very good argument you can make that the change is in the city's best interest (perhaps, because something has changed since the master plan was originally adopted). If not, just forget it.

The whole idea in construction contracting is to make more money with less effort and risk, not the other way around. Take my advice. Get to know your city planners and administrators. Study the city's master plan. Select property locations that are compatible with the city's objectives, as well as your own. Don't waste your time and money fighting uphill battles over ill-conceived projects on ill-chosen plots of land.

If you believe there are good reasons for a change in zoning or for special consideration in granting a permit, get professional help to prepare your case. Line up some heavyweights on your side. But be selective. Not all architects, engineers and attorneys are experienced in dealing with public agencies.

Zoning Variances

If you decide to request a variance or special consideration on a permit, approach the department staff with a healthy degree of respect and patience. The last thing you need is an enemy in City Hall. Don't let some zealous out-of-town speculator talk you into doing anything that will damage your reputation as a responsible member of the community. You have to work with those same city officials year-in and year-out. Your out-of-town client doesn't. Believe me, city officials tend to stay in their roles for the long haul and they have elephants' memories when it comes to troublemakers.

Here's the approach I use. At the outset, ask the city or county officials for the latest low-down on all approvals, permits, testing and certifications that'll be necessary to complete your project. Then, start working with architects and engineers. Don't assume that they already know what you know. They probably don't. Even if they do, what they know is probably at least partially out of date. So be proactive.

If necessary, ask that the city's officials meet with the owners, architects and engineers. Clarify the process to everyone. Let the city officials know what you're planning and get their advice on the best way to get approval, and the time that will be required. Try to discover the snakes in the grass before they jump up and bite you. *Don't make any significant investment until you know the guidelines that apply and you've decided that you'll be able to stay within them.*

If you have a meeting, take careful notes. Type up the notes and distribute a copy to everyone involved. It's amazing how effective this will be in helping everyone recall what was discussed and decided. Here's a tip for any meeting — always offer to take the minutes of a meeting if there isn't a secretary whose specific job it is to do it. I know it's a pain that you'd rather do without, but taking the minutes puts you in control of what the minutes say. Otherwise, you may find that what you think was agreed upon is different from what the others think they agreed to. This way, the minutes always reflect what you think was agreed upon, and if the others disagree, they're the ones who have to go to the trouble to get the minutes changed — which often they won't bother to do.

Planning and Building Departments

Every builder should distinguish between the responsibilities of the Planning Department and the Building Department. Try not to get the two confused. You have to take the right problem to the right department at the right time in the approval process.

If you take questions about parking space requirements and public access to the Building Department, you've shown yourself up as a rank amateur and they'll treat you as such. Those are Planning Department problems. But questions about occupancy permits or life safety systems won't be answered by the Planning Department. That's the business of the Building Department.

The Planning Department passes judgment on issues about property usage such as setbacks, height restrictions, building function, materials, traffic control, loading and the environmental impact of a project.

The Building Department is concerned with public safety. They review construction methods and building systems, including mechanical, electrical and fire sprinklers. They also pass judgment on anything related to structural requirements, heating, cooling, roofing and exhaust systems, ramps and handicapped facilities.

If that's clear, let's move on to the other city and county agencies you'll have to deal with.

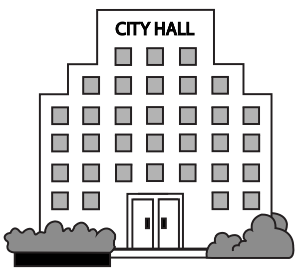
Other City and County Departments

Another agency you'll perhaps meet is the Health Department. They review and inspect facilities where food is processed or prepared for public consumption. They also have authority over medical and drug processing facilities, in addition to water wells and disposal facilities.

Typical concerns of the Health Department include sanitation conditions, air conditioning, range hoods, grease traps, sinks, drains, ceiling, wall, and floor finishes, paint colors, tile textures, water temperatures and equipment types.

My advice is to include the Health Department in the process if your project requires Health Department approval. Schedule a meeting with the department officials for yourself, your client, his architect and his interior designer. At the meeting, get a copy of the filing requirements that apply to the project.

In some cities and counties you may have to file plans with both the Health Department and the Building Department. In others, you'll only file with the Building Department and they'll route your plans through the Health Department. But be sure to ask what the process is in your community — don't assume anything.



The Health Department in many smaller cities won't have the staff or experience needed to review your plans. Actual checking may have to be done by the County Health Department, which will add time to the approval process that you'll have to make allowance for.

Another stop on your tour through City Hall should be the Fire Marshal's office. The Fire Marshal focuses on two issues. The first is the availability of sufficient water to fight a fire. Are the water volume and pressure and hydrant locations adequate if there is a fire? Second, they decide if fire sprinklers and smoke detectors are needed. If so, they approve the location of sprinkler outlets, control valves and shutoffs. The Fire Marshal's office also sets the distance between fire hydrants and determines where the hydrants will be located. Be sure to review the Fire Marshal's decision and request a change if it will cause you a real problem. Putting the hydrants in a bad place will cost you plenty.

The Public Works Department is an interesting little agency with some rather large responsibilities.

Public Works oversees streets and street widths, parking lots, sewer lines, water lines, storm drains, bridges, dams and other public systems. If your project involves anything in these areas, you'll need to visit the Public Works Department. Your civil engineer is the professional most involved with this agency. If you need help deciphering their requirements, ask him.

The sewer, water, power and telephone companies have their own engineering staffs and requirements. You'll deal separately with each of them.

Finally, there's the agency that provides public transportation. The Transportation Agency sets standards for street turnouts, turnarounds and even street widths in some cases. Also, they can veto power line locations.

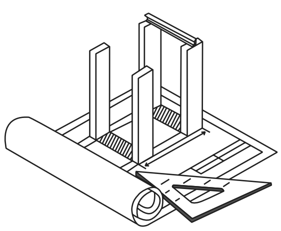
So, call them before going too far with your work if they could be remotely involved with any aspect of your project.

In short, there's a myriad of agencies and departments in City Hall that builders have to deal with. Learn your way around this puzzle early in your construction career. You can't make a profit while you're groping your way through the maze, trying to find the exit.

Plans and Specifications

Some builders never have the opportunity to participate in the design process. However, my experience is that input from a construction contractor during the design phase can often cut costs and reduce the construction time considerably.

If an owner-client invites you to review his architect's plans before they're finalized, or if the designer is working for you, make the most of the opportunity. Be ready to provide the insights and suggestions that only an experienced builder can supply.



Start by keeping the plans and specs simple, well-organized and to the point. The on-site people who have to work from the plans aren't college graduates. And they're certainly not mind-readers. Make the instructions as clear as is humanly possible. The fundamental idea behind all plans and specs is communication. Don't load your plans with obscure details and boilerplate language that doesn't really help convey the intent. Make your plans models of clarity. And again, don't assume everyone automatically knows what is intended by each particular feature of the plans. If there's likely to be any doubt, spell it out.

Plans and specs serve two distinct functions. *The plans (working drawings, construction prints, or blueprints) describe how everything goes together — how the various products and materials are to be assembled. Specifications describe the materials to be used, the conditions under which the work is to be done and any tests the materials have to pass* (for instance, the concrete you have poured may have to pass a slump test). Here's how you, an experienced builder, can help the designer. You know what type of construction goes up quickly with the least waste and trouble. You know which building techniques work the best, save the most money and take the least time.

Suggest that the designer avoid details that will be more difficult to assemble or that will involve some risk from your standpoint. Recommend materials that are easy to work with or are more readily available. Favor construction methods that can be done with your own crews and without special equipment. Discourage designs that require expensive specialist subcontractors and special facilities. Following your suggestions could cut five to 15 percent from the project cost, while shortening the project duration.

Then go one step further. Talk to the architect and engineer about the content and assembly of the plans and specs. Review the list of drawings and specs to be prepared. Eliminating redundancies, conflicts and unnecessary effort could save five to 10 percent of the design cost. And plan to check the drawings and specifications yourself.

Your help with the specifications should save the architect lots of time. You already know what materials are appropriate for the type of building to be constructed, saving significant design time. The architect should pass these savings on to the project owner. Keep in mind, though, that architects and engineers like to make money also. They're not going to show you how they can reduce their fees. It's up to you to make the suggestions and to show that the suggestions are valid.

Here's another trick to reduce the design cost. Set a reasonably short time limit for preparing the plans and specs. Have the designer agree to a deadline before giving him the job. The shorter the period of time available to prepare your documents the more efficient your designer has to be to complete the job on time. Of course, setting a tight deadline shouldn't force the architect into overtime work. That defeats the purpose. Apply just enough pressure to assure continuous and efficient effort on your project without requiring overtime work.

Pay special attention to all the major pieces of equipment your designer selects. Design people often don't know the up-to-date cost of equipment until the bids are opened. *The designer's choice is seldom based on a cost comparison.* Propose equipment that fits into the construction budget, meets code requirements, is compatible with the other systems, has adequate capacity and, in your experience, is reliable.

"Eliminating redundancies, conflicts and unnecessary effort could save five to 10 percent of the design cost."

Never allow the owner and architect to gallop through the design process unbridled without an appreciation of costs. Failure to focus on costs in the design stage is sure to bring in bids that are over budget. That wastes everyone's time with redesign and more bids. It probably delays construction several months. Meanwhile, inflation boosts the project's cost by a couple of percent.

Recognize that both over-design and under-design are hazards in this business. Although over-design is far more common, some architects don't do enough drawings to completely describe the work to be done. Other architects insist on making minor, or even fairly major, changes throughout the drawing, bidding and even construction processes. An architect who over-designs is adding unnecessary costs. An architect who under-designs, or can't make up his mind, can cost the contractor all of his profit and more.

Building Codes

It may seem strange that we can almost reach the end of this book without mentioning building codes. This is because building codes tend to affect architects and engineers more than builders, as the code(s) mostly define what can be built, rather than precisely how it is built. However, there are many instances where the permissible methods of construction are defined, so it pays you to be reasonably familiar with the applicable building code.

As the ultimate builder, you're responsible for seeing that what you build meets the applicable code, especially since you're the one who'll have to change it if the inspector finds that your construction fails to meet the code. So, make sure that the plans and specs are reviewed by the building inspector before you start, to catch any possible code violations before they cost serious money to correct.

If you're building for an owner, ensure in the original contract that any costs of making corrections to meet the building code due to design irregularities are the owner's financial responsibility, rather than your own. Of course, if you're the owner (i.e. you're building spec property), then it will be your dollar that you'll have to spend to correct any code violations, so be especially certain that your plans and methods of construction meet the applicable code before you get started.

Applicable Code(s)

One of the most common complaints you used to hear from architects, engineers and building contractors was that there were too many different building codes. It seemed that every city, county and state had its own idea of what constituted good and bad construction.

Of course, every city, county and state has the perfect right to make up its own laws, ordinances and regulations — including laws that control building. And there was a time when most did. But the result was far too many different codes. What was perfectly acceptable in one community may have been strictly prohibited in the community right next door. That was foolish.

The profusion of codes made the task of architects, engineers, builders and inspectors far more difficult than it needed to be. Fortunately, times have changed. By the mid-'90s, most communities had adopted one of three model codes. The Uniform Building Code was the most widely used, followed by the National Building Code and the Standard Building Code.

In 2000, the first editions of the International Building Code (IBC) and the International Residential Code (IRC) were published by the International Code Council (ICC), followed by further editions in 2003 and 2006. The IRC is a subset of the IBC (although it has almost as many pages), which deals with One- and Two-Family Dwellings and Townhouses.

By April, 2006, forty-five states plus the District of Columbia and the Department of Defense had adopted one of the editions of the IRC. Forty-seven states plus DC and the DOD had adopted the IBC. Other codes published by the ICC are Electrical, Energy Conservation, Existing Buildings, Fire, Fuel Gas, Mechanical, Performance, Plumbing, Private Sewage Disposal, Property Maintenance, Urban-Wildlife Interface and Zoning. There is a county-by-county code adoption chart that can be accessed by going to www.iccsafe.org/government/jurisdictionadoptions.xls.

California is somewhat of a hold-out, and many cities in the state are still using the 2001 California Code, based upon the 1997 Uniform Building Code. If you're planning to build in California you'll need to contact your local building department to determine exactly what code is applicable in the community in which you plan to build. The code that applies is the one for where you plan to build, *not* the one for where your office is located. Some owners will move their project out of a city into an unincorporated area of a county in order to avoid some restriction imposed in the city code that's not in the code adopted by the county.

You need a copy of, or have easy access to a copy of, the current building code in force in the communities in which you plan to build. Some bookstores sell the International Residential Code. If your local bookstore doesn't have a copy, you can buy it directly from the ICC. You can order it, and any of the other codes, on-line at www.iccsafe.org. It comes in either bound or loose-leaf versions, as well as on a CD-ROM. I recommend the CD-ROM version as it has an excellent search capability that enables you to find the references to any aspect of the code that you're concerned about in a matter of seconds, without having to plow through the 600 or so pages of the IRC or IBC. Ideally, you should get The Designer Collection CD-ROM, as it contains, all on a single CD-ROM, the:

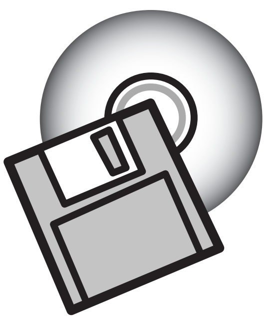
- International Building Code®
- International Residential Code®
- International Existing Building Code®
- International Fire Code®
- International Energy Conservation Code®

Unfortunately, knowing the applicable code isn't easy. The first problem, though not a difficult one — you just have to ask — is to find out which code applies in the jurisdiction in which you plan to build. The second problem is somewhat more profound. The building code, whichever one is applicable, is a complex law intended to be enforced rather than read and understood. Some hard-to-understand sections refer to sections that may be even harder to follow. The code seems to grow larger and more complex every time it's revised. There are exceptions, within exceptions, within other exceptions. A lawyer, used to handling intricate tax problems, would feel right at home with the building code.

But you can't spend a career mastering the building code. At least, you shouldn't. Your job is building, not nit-picking. As a builder, you need to know just enough to stay out of trouble and to avoid expensive mistakes. Fortunately, there's a book published by Craftsman Book Company that helps you do just that. *Contractor's Guide to the Building Code*, by Jack Hageman explains the requirements of the 2006 IRC and IBC, appropriate to those architects, engineers and builders who are working in jurisdictions which adopt these new codes.

Every three years the codes are revised and republished as a recommendation to the nation's building departments. Each county or city then decides if it will adopt the new code as a regulation for that community. The code by itself is not a legal document — only when it is adopted as an ordinance of the county or city does it have the force of law.

Contractor's Guide to the Building Code is not the actual building code, so don't try quoting from it to any building inspector. Instead, use this manual as your guide to specific issues which have a habit of rearing their ugly heads and as an answer book on code problems. Go to the chapter or section that addresses the aspect you're concerned about. Read enough so that you have some background on what the code demands. Then go to the code itself to check out the details. Use the index to direct you to the code sections that apply to your situation, and use the IBC and IRC CD-ROM search facility to find the sections covering your specific area of interest. This should save you hours of valuable time and prevent expensive mistakes.



Disputes

Whatever the code in your city, if you're a builder, you're going to have occasional building code problems. Every contractor has had an inspector hold up his job or delay a permit until some minor discrepancy is handled just the way the code requires. From your standpoint, following the code is usually just an annoying and expensive necessity. You feel you know how to build properly and don't need a government agency telling you how. But the building department, and probably the owner who set your project in motion, regards the code as a good defense against poor practice that might otherwise plague generations of occupants of the building you erect.

No matter how carefully you build and how knowledgeable you are about the code, you're going to have the occasional dispute with an inspector. Let me offer you some advice. I've been involved in a number of disputes and have been in a few arguments. You're not going to win very many direct confrontations with a building department. There's a lot you can do to get them to see your side of the argument.

"An inspector can require anything the code demands. But that's all!"

First, understand that the building department holds all the best cards. They can make any builder's life very unpleasant and cost him a lot of money. They have the full power of local or county government behind them and can use it effectively to compel compliance on your part. But they would usually prefer to have your voluntary cooperation.

Adopt this attitude toward the building department and inspectors you deal with: "You have a job to do. I have a job to do. Together we're going to put up a building that both you and I as professionals in the construction industry will be proud of." The more you think of building officials as implacable adversaries, the more likely they'll become just that.

In a dispute with the building department, you do have one point in your favor. The inspector didn't make the rules and can't write the code to fit your situation or change it to suit his argument. He can only enforce the code as it's written. *An inspector can require anything the code demands*. But that's all! He's on very shaky ground if he insists on something that isn't in the code book. That's why you need a copy of the code. If a dispute arises, have the inspector cite the specific section and words involved. Then read those words yourself in your copy of the code. If those words don't support the inspector's position, you're very likely going to win the point.

Of course, inspectors make a living by knowing the code. They probably know it much better than you ever will. But they can be wrong. So don't be afraid to request the reference to a specific code section; read that section and form your own opinion of what is required. If you feel the inspector is wrong but you can't persuade him to change his mind, in every jurisdiction there's a perfectly good appeal process.

Summary

Before you choose your design professionals, spend some time getting acquainted. It's time well spent. When you have a choice, work with architects and engineers who are sensitive to the building contractor's viewpoint.

Zoning and permits are headaches for all builders. Try to conform to the city's master plan. Avoid going against the grain. Get to know the city planners and administrators. Let them know that you're a responsible, quality-conscious builder. Know the rules before you start building and keep everyone on your project team informed. Don't hesitate to schedule meetings with officials in the departments involved. City and county officials are paid to have meetings — all sorts of meetings. Give them the low-down on what you're doing. Find out what they need from you, and do your best to comply promptly.

Work closely with the designer whenever possible. Begin your cost-control effort while the project is still on the drawing board. Be ready with suggestions for cutting construction costs without sacrificing quality or utility. Suggest alternative materials, equipment and scheduling — whatever will bring down the overall cost of the project. No one is better able to control costs than an informed and alert builder.

Make sure you have a copy of the applicable building code(s) for the jurisdictions in which you plan to build. Spend some time studying them and use the *Contractor's Guide to the Building Code* as a starting point for understanding any concerns you may have about what the code requires, but be sure to check the actual code, as that's the document that has the final word.

Second, for the Third Time

Are You Sure You're in the Right Business?

If you bid jobs to obtain contracts, you'll come in second or worse far more times than you'll come in first. So, work on a fee basis whenever possible. Try to make it the lifeblood of your construction business. If all legal work went to the lawyer with the lowest bid and all construction work was done on a fixed fee, builders would drive Jaguars and lawyers would drive pick-up trucks!

But if the market you serve runs on competitive bidding, it's survival of the fittest. You'd better take a close look at your competition. What kind of companies are you up against? Are they big or small? Are they specialists or general contractors? How many are there in your area, in your specific line of construction work?

If you pick up a bidders' list on a project and find there are 35 contractors listed, you're in trouble. Unless you've seen something that the others have missed, your chance of success is less than 3 percent. Odds like that don't make anyone rich. In fact, you probably wouldn't have much chance of breaking even on that job even if you were awarded the contract, because the only way your bid could have been low enough is if you made an error in your estimate.

To live on competitive bids, you'll have to improve your odds significantly. If the odds are less than one in four, forget it. You'd be better off playing golf. The simplest and most direct method of improving your odds is to develop special skills or knowledge that let you compete in an area that isn't already overcrowded.

Here's an example of what I mean. I have a contractor friend, Bob, who does quite well building small concrete dams, equipment bases, water channels and pumping stations for public agencies. Here's why he's successful: He still has to face the public bidding process, but there are only three or four contractors in his area that bid on that type of work.

Bob used to handle residential foundations, concrete slabs, sidewalks and retaining walls.

He had to compete with every joker in town who owned a pickup truck and a trowel and thought he was capable of pouring and finishing mud. With 800 slab finishers running around loose, Bob ended up donating his time on most of the projects he won.

"There's no need for yet another builder with the same skills, equipment and knowledge in a saturated market."

He had to make a change. And he did. Bob's still in the concrete business, but his clients are well-financed municipal governments. Sure, the paperwork is more demanding and the job specs are more complex, but governments tend to pay their bills on time and in full, with little argument. His competition has been reduced to a handful of firms. That makes his pricing policy much more realistic. Bob now makes a good living and, more importantly, he feels good about his business and his future.

Here's the moral to my story. If you're going to live on competitive bids, find yourself a solid, profitable niche. Otherwise, your best bid will come in second at least 90 percent of the time.

Of course, it's not easy to find that niche. But, there are probably over 500,000 small construction markets and specialties in the U.S. — plus many that are still waiting to be discovered.

Where did I get the half-million figure? Well, start with the three broad areas of building construction — residential, commercial and industrial. Then add government work, remodeling, insurance repairs and non-building construction (drainage, power lines, etc). That's seven major construction categories. You can probably think of others I haven't mentioned. Then, multiply those seven major categories by the 15 or 20 specialty subcontractors that service each of those categories. That makes more than 100 different construction specialties. Then, multiply by the 4,000 to 5,000 communities in the U.S. that are large enough to support a specialized construction contracting business. That gives you somewhere between 420,000 and 700,000 options available to you when selecting what you're going to do and where you're going to do it as a construction contractor.

Of course, many of these markets are already experiencing an overabundance of skilled laborers. There's no need for another builder with the same skills, equipment and knowledge in a saturated market. But, other markets are probably under-represented. And there's probably a good reason why. Either the work is too remote, requires too much sales effort, too much equipment, too much paperwork, too much capital, or there's some other disadvantage that discourages other contractors from entering that market. But some bright, young, energetic contractor is going to discover that niche and find a way to overcome the disadvantages that have discouraged all others. If you're that contractor, you've stumbled onto a gravy train.

And once in a while, a new market opens up. It could be due to sudden growth in a community, such as a new industrial park being established in your area. Maybe a new technology has come on the market (such as solar roof panels), requiring special skills and equipment for installation. Perhaps there's been a change in the type of buildings needed (think of the growth in the fast-food restaurant industry in the '80s, for example). Contractors who guess right about a new market and are ready to serve it first will become established and profitable participants as the market expands.

No matter what the reason, don't keep slugging it out with the competition in a glutted market. Look for an under-served market or one that's growing that gives all competitors a chance to thrive. And be ready to overcome whatever disadvantages come with that market.

If Bid You Must. . .

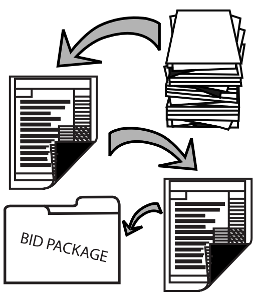
Here's the first rule of bidding, if you haven't learned it already. *Always bid what you've been asked to bid.* Don't qualify your bid without specific written direction from the architect, owner or contracting official.

Bid to the Plans and Specifications

The fastest way to get yourself cut out of the bidding process is by not bidding on what you're asked to bid on. The owner wants to compare bids as apples to apples, not apples to oranges. If the plans and specs call for painting the exterior walls with catsup using a toothbrush, then that's the way you should bid it. Maybe you feel cherry-flavored bubblegum applied with a nail file is the better way to go. You have a perfect right to suggest that procedure and offer an alternative (generally lower) price in an addendum to your bid. But in your basic bid submission, you must bid the cost of putting on catsup with a toothbrush. You can press the argument for a spec change later, with whoever has authority to change the specs.

The bid package will identify who is authorized to interpret and change the plans and specs. All questions and suggestions should go to that person. Usually, this will be the architect. But the owner can fill this role, as can an engineer, a construction manager, a construction foreman or a secretary. It doesn't matter who's handling the job. What *does* matter is that you address the right person and give them time to respond.

It's usually to your advantage to respond to the "or equal" clauses in the specs and suggest where savings are possible. If your suggestions are adopted, you could gain a distinct advantage over the competition. Here's an example: The specs call for 1,000 chrome-plated hook plates. You have a ready source for 1,000 vinyl-coated hook plates at $10 apiece cheaper than the chrome-plated model that you expect your competition is pricing in. Bid the chrome-plated hook plates, but, in an addendum, point out that there's a $10,000 savings to be made by accepting the vinyl-coated hook plates in place of the chrome-plated ones. That's a $10,000 bidding advantage. And that's the name of the game — the bidding advantage. *Figure out a better, quicker, cheaper way to build and you'll dramatically improve your chances of getting the contract.*



Every time I pick up a bid package, I begin by looking for anything that's going to be to my advantage. Search through the specifications for the "or equal" clauses. Point out each one to your subcontractors, if you're getting bids from them for parts of the overall job. Look at the alternates on the job. Many contractors have submitted the lowest base bid, only to end up many thousands of dollars higher in total when all the alternates are considered.

Look over the architect's and engineer's detailing. There's usually a way to simplify most fabrication and construction. When you find opportunities for savings, keep what you've found under your hat. Bid to the specification, but attach addenda showing how significant savings can be made by using your alternative approaches. That's your bidding advantage.

Bid Peddling

Bid peddling is endemic in the construction industry. Owners do it. Contractors do it. I don't think it's either fair or good business.

Here's how it works. An owner receives a bid from you. He then offers the job all over town to anyone who will do the work for a few dollars less. He plays one contractor off against another. And he might do the rounds two or three times until he feels there's no more flesh to be stripped from the bones.

Before criticizing the practice, let me remind you that general contractors are notorious for bid peddling among subcontractors. After a contract has been awarded, it's quite common for the winning general contractor to ignore the subcontract bids he used to win the job. Instead, he solicits new subcontract bids or even openly offers the work to other subs who will take it at a lower price. Many general contractors feel they've a perfect right to get the lowest possible price any way they can. I won't argue with that, but I won't recommend it either. It doesn't breed loyalty between the general contractor and the potential subcontractors — and no general contractor can get very far, for very long, without competent, reliable subs.

Open bidding helps curb a client's bid-peddling instincts, but nothing will stamp out the practice completely. Short of being threatened with a lawsuit, few things stop an owner from approaching the second lowest bidder (or even another, originally uninvited bidder) and suggesting a price that would get him the job. The only practical way to protect yourself from bid peddling is to know who you're bidding for and their bidding history.

"...no general contractor can get very far, for very long, without competent, reliable subs."

Of course, you're essentially always protected from bid peddling on government work. The bidding procedure is established by law. That advantage encourages many contractors to handle only government work — city, county, state and federally-funded projects. In fact, many large construction firms do government work almost exclusively. Of course, clean bidding isn't the only reason to specialize in government work. Governments have the right to tax, which creates deep pockets and almost perpetual financing. Government agencies burden you with requirements that often seem insane. But, they won't peddle your bid and they will pay up when you submit your invoice, assuming everything else is in order.

Extras

Every extra for which a contractor claims a charge probably seems like price gouging to most owners. But construction is too complex to think of everything before the work begins. And it's too permanent to ignore the changes the client wants to make during construction. So, there will always be extras. And, there will always be disputes over the legitimacy of the costs for these extras.

Any time you're asked to add something that wasn't in the original plans and specs, tell the owner what the extra charge for the change will be before you make the change, and get his agreement *in writing*. These are perfectly justifiable charges. The owner has to pay for extras because the cost for doing them wasn't included in your original bid. That's why it's important to watch out for any extras that get slipped in. And it doesn't matter how small they are, make sure you point out to the owner that this new request represents a change to the original specs. It may be a trial run on his part to see how much he can get away with.

Even if it's only a very small change and you decide not to make an extra charge in this instance, make sure you inform the owner what the cost should be and that you're including it just this time, free of charge. And, make a point of telling him that for any further changes you'll have to charge him. Invoice the client for your extra charges at the end of each month. Include supporting documentation such as a copy of the owner's request for the change and his signed agreement to your charge. Have your time tickets and material receipts available as back-up, if needed. *Never, ever wait until the end of the project or you'll be facing mass amnesia.*

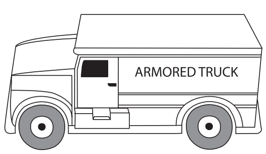
Make sure you include all your extra costs in the amount you charge, not just the cost of labor and materials. Exactly as you did in your original bid, you'll need to charge for supervision, overhead, taxes, insurance, bonds and a reasonable profit. It's foolish to handle extra work at just your cost or even below your cost. Extras have to carry their full share of overhead.

Here's how important it is to collect for extras. Say you're working on a $200,000 project and you're asked to do some extra work that wasn't included in the original plans. And let's say your cost for the extra work will be $2,000 including overhead. You included a $20,000 profit in your original estimate for the completed $200,000 job (i.e. 10 percent). Now, you're debating with yourself whether to charge the owner for the extra $2,000. If you don't, your profit on the job will be down to $18,000, since the only place the additional $2,000 can come from, if not from the owner, is from your profit. That's a 10 percent drop in profit. In effect, failing to charge for the extra $2,000 work is like doing an additional $20,000 worth of work at no profit. And the slimmer your profit margin, the more important every little bit of extra cost becomes.

Collecting for extras gets tougher as the project progresses. That's especially true if the job goes over budget, even if you're not to blame. The only way to get paid for all the extras is to document every charge. *Good paperwork wins claims for extra charges — especially if you have to go to court.*

Protect Your Profits

Don't let your enthusiasm for the job, or your belief that you're preserving good relations with your client, prevent you from collecting for extras. Every extra cost that's not charged comes right out of your profit. There's really only one slush fund in any project and that's your profit. Nothing else is adjustable. When the profits are gone, the reason for doing the job is gone. But you're still contractually obligated to complete the job, and the cost is now coming out of your pocket, not the client's. That's the way the system works.



Here's another note of caution. Don't inflate your billing for extras. Be firm but fair. Gouging an owner is a sure way to lose repeat business. At best, you'll lose a recommendation. And at worst, you'll end up in court. Even the appearance of gouging may be enough to upset your client, so be sure to document all your extra costs in as much detail as possible.

A customer generally won't quibble over a $200,000 project bill, because he doesn't have a good handle on whether it should be $195,000, $200,000 or $205,000. But a charge of $150 to include an additional wall lantern can cause all sorts of arguments. That's because the customer has seen the same lantern at his hardware store for $80 and thinks he's being gouged when asked to pay $150 for it.

Clients find it very easy to forget that you have to pay the electrician to install it, insure him while he's doing the job, cover your overheads, etc. and make a small profit. So be prepared to spell out on paper exactly why an

$80 lantern off the shelf from the store becomes a $150 bill when it's installed on his wall. No amount of spiel and arm-waving will prevent the client from feeling he's being gouged (all over a trifling $150 bill), but a detailed breakdown on a piece of paper will soon defuse the issue. Just ask him, if he was in your shoes doing the job, which line items he would leave out — he'd find it very difficult to find any.

"If he doesn't accept the one bottom-line figure, you'll have to break it down into individual costs."

Try to gather all extras into one catch-all estimate that comes to a few thousand dollars. When you present the estimate, don't break it down into too much detail. If he doesn't accept the bottom-line figure, you'll have to break it down into individual costs.

If you do break it down, just list the materials, for which you'll have actual receipts. Try to avoid listing the individual installation costs. It's human nature to question how long it should take to install one of the small extra items, so be prepared with detailed paperwork.

One final point on extras — don't offer to let the owner purchase the extra items himself and just have you install them, free of charge, of course. Remember that you're entitled to charge for supervision, overhead, taxes, insurance and a reasonable profit on any extras. If he's already purchased the item, or if it's some item with strong sentimental value he's brought with him from his previous residence, don't refuse to install it for him, but say that you'll have to charge a small fee to install it — he'll understand.

Negotiated Fees and Design-Build Contracts

Many projects are now built on a negotiated-fee basis. It's an informal procedure that helps both the owner and the builder, especially if the project isn't yet cast in stone at the time of estimating. Both parties can then adjust the amount of work done and the prices to meet economic and budget restraints. It's not a bad way to go.

Here's how it's supposed to work. The owner selects three or four general contractors on the basis of their perceived merit and reputation. He asks each contractor to evaluate the plans, as they presently exist, and prepare an estimate. The estimate is for information purposes only, although it may include fixed subcontract bids. Each contractor then bids an hourly labor rate and a fee for the project that covers his supervision, overhead costs and profit. The project will be undertaken for the actual cost of the labor (the number of labor hours taken times the hourly rate bid) and the materials, plus the negotiated fee.

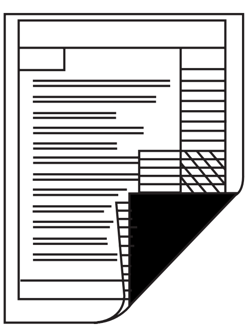
"A major consideration may be how long you can afford to carry expenses before the owner has to pay the fee."

The most enterprising contractor with the lowest bid on his hourly labor rate and his fee will generally get the job. The unsuccessful contractors are usually compensated for their time and effort in preparing their bids. This arrangement is fair to all parties involved. Of course, negotiated fees aren't a cure-all for poor estimating skills. If you were a lousy estimator before you got a negotiated contract, you'll still be one when you land your first negotiated job. Nor is the negotiated-fee arrangement completely free of drawbacks. For example, owners can negotiate with several contractors at the same time. This can open the door for bid peddling.

If you do enter into a negotiated-fee competition, prepare yourself for an interesting free-for-all. You'll be pushing not only your fee price and hourly labor rate, but your skill, experience, staff quality, financial capability and your personality. A major consideration may be how long you can afford to carry expenses before the owner has to pay the fee. The size of your reserve fund can be an important issue.

The advantage of a negotiated fee project is that you don't have to worry about the fine details of materials and labor estimates. They're going to be paid, generally on a monthly progress payment basis. Also, you don't need to be concerned about extras, as they'll be covered automatically. This type of contract is often used when the project is expected to evolve as it progresses, so the labor and materials are not necessarily fixed at the start of the project.

Estimating Your Fee



Estimating your fee presents a big challenge, depending upon just how broad the plans are at the beginning of the project. If there's a chance that the project may evolve considerably as it progresses, you may not want to bid a fixed fee, but rather a fee based on labor hours to complete the project. This will cover you if the project keeps growing and takes, say, 50 percent longer than the client assumed at the start of the project. You may want to add a clause to your bid that reserves the right to increase your fee proportionally if the project continues for more than a set length of time.

You may feel that standard competitive bidding really demands less from you as a general contractor. You pick up the plans, assemble your bid and submit it to the owner. When the bids are opened, you either win or lose. Nothing counts except the price.

Negotiated-fee contracts will almost always be profitable. They should be, unless you've made some major mistake in writing the contract. *All the material and labor costs are paid for, whatever they turn out to be, and your* *fee should cover the time you spend on managing the project, unless there was a huge time overrun that you hadn't anticipated.* Also, there's usually less competition bidding on this type of job. In a negotiated-fee competition,you should get one out of every three or four jobs. If you're invited into a negotiated-fee competition, give it a try. You just might find you like it.

We've seen that accurate estimating may not be that big a deal for a negotiated-fee contract — unfortunately, they're only a small minority of the jobs that you'll encounter. Much more common is the competitive bidding job, which is based on submitting a fixed bid for doing a fixed amount of work. In this case, the accuracy of your estimate is paramount. So, let's spend some time seeing if we can hone your estimating skills because, in order for you to thrive in the construction business, you have to be a good estimator. Overestimate and you'll lose the contract, underestimate and you'll lose your shirt!

Accurate Estimating

Accurate estimating sounds like a contradiction, doesn't it? An estimate is a guess and how can a guess be accurate, since you can't exactly measure what the cost of doing a job will be? *However, an estimate has to be accurate if you're going to get the contract and make a decent profit on it.* And there are tools to measure what the cost will be. Modern computer estimating programs have advanced to the point that they're easy to use and can produce accurate estimates, especially if you update the database with actual costs of previous jobs to use on bidding future jobs.

Estimating is the subject of entire books, so I'll only be able to cover the main points in this chapter. For greater detail, you should invest in a good estimating program and its accompanying manual. One such estimating program that has received national acclaim is The National Estimator, developed by Craftsman Book Company, which is included in a number of their manuals, such as the *National Home Improvement Estimator* (see Appendix 4).

There are basic steps necessary to prepare an estimate that we should discuss. Many of them may seem obvious, but are often overlooked.

- Make sure you have a complete set of the bid documents, including specifications and drawings.

- Read the documents carefully and understand what's required. If you're not sure of something, submit a formal request for clarification. Don't "assume."

- Understand what type of bid is requested:
  - Lump-sum bid
  - Bid and alternate pricing bid
  - Base and unit costs bid
  - Time and materials bid
  - Time with materials supplied by owner bid
  - Cost plus fixed fee bid
  - Negotiated bid
  - Design and construct bid

- When is the bid due and where is it to be submitted? There's no use doing all the work if you're late submitting the bid.

- Collect all drawings and do an accurate take-off.

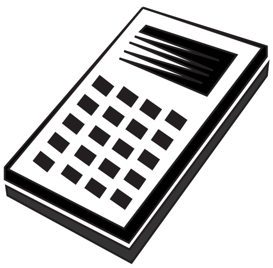
Performing an Accurate Take-Off

You'll need to do an accurate take-off of all the materials needed for the project. This is a whole subject in and of itself, and is the foundation of a precise estimate. Unless you have an exact list of all the materials to be purchased and installed, you haven't got a chance of putting together a viable estimate. Break down the take-off into the various trades, such as concrete, framing, roofing, plumbing, electrical, sheetrock, cabinet installation, painting, carpeting, landscaping, etc. Typically, there will be different sets of drawings for each trade so it's easier to spot missing or duplicated items.

Set up a standard sequence for your take-off to use from one estimate to the next, or from one estimator to another (sometimes on a large project, two or more estimators will split up the take-off). Following a set routine makes omitting or duplicating something much less likely. For example, you might start by listing lighting fixtures, followed by lamps, followed by wiring devices, and so on. Then, list conduit from small sizes to large sizes as a group of the same type, followed by fittings, then different types of conduit and fittings. Make an index to list each page of the estimate and be consistent for each estimate. A well-planned, organized format allows you to review an estimate quickly and easily, without needing to run back to the plans, worksheets or costing sheets.

The key is to keep the take-off process as simple as possible. Here's a typical sequence that you can use, for the electrical part of the job:

1) Lighting fixtures: Plaster frames, remote ballasts, stem hangers, spacers, fixture couplings, tandem units, suspension systems, floodlight poles, fixture mounting brackets, special



backing, dimming equipment, lighting control, interference suppressors, diodes, in-line fuses, hanging materials

2) Lamps: Incandescent, fluorescent, mercury vapor, high-pressure sodium, low-pressure sodium

3) Wiring devices: Lighting switches, single and duplex receptacles, special receptacles, cover plates

4) Boxes and box fittings: Fixture outlet boxes, single-gang boxes for lighting control and receptacles, special outlets, multi-gang outlets for double or more devices, junction boxes

5) Safety switches: Size and type for indoor/outdoor, fused/non-fused, general/heavy-duty, horsepower rated, magnetic starters, combination switch/starters, manual motor control starters, wireway/gutter, large pull boxes

6) Switchgear: Metering equipment, distribution switchboards, motor control centers, lighting and power panels, transformers, terminal cabinets, feeder circuit breakers

7) Conduit and fittings: GRC, flexible, EMT, PVC, connectors, couplings, elbows, locknuts, bushings, straps, hangers, conduit bodies

8) Wire and cable: Control wire, building wire, feeder cable, splices, connectors

9) Equipment hookup: Air handling, exhaust, air conditioning, boilers, chillers, air compressors, automatic doors, conveyors, pumps, mechanical equipment, control center devices

10) Trenching and excavation: Various trench sizes, excavation for manholes and underground boxes, concrete encasements, sand, backfilling, cleanup, saw cutting of pavement, core drilling

11) Demolition: Disconnection of services and equipment, removal of fixtures, conduit, wire

Your take-off should look something like Figure 13-1, which is a single page listing of the electrical take-offs for one drawing (Figure 13-2), a small office complex and workshop. You'll note that this sheet of the take-off is the first of seven sheets that covers the lighting fixtures and lamps on a number of the electrical drawings labeled E3, E4 and E10. This example is taken from *Estimating Electrical Construction*, by Ed Tyler, published by Craftsman Book Company.

TAKE-OFF WORKSHEET

TWS-E.xls

ESTIMATE NO. M351 ESTIMATOR: ED TYLER JOB NO. AC-1

JOB DESCRIPTION: ADVERTISING CO. OFFICES AND SHOP DATE: 8/23/2006

BID DUE DATE: T.B.A. CHECKER: SUE SHEET NO. 1 OF 7

CATEGORY LIGHTING FIXTURES AND LAMPS

Drawing No.												
ITEM	E3	E4	E10									TOTAL
A	1											1
A1	46											46
B	4											4
C	1											1
D	4											4
E	3	1										4
E1	1											1
F	2											2
G		2										2
H		2										2
J		2										2
K		10										10
L		4										4
M			12									12
N		1										1
												0
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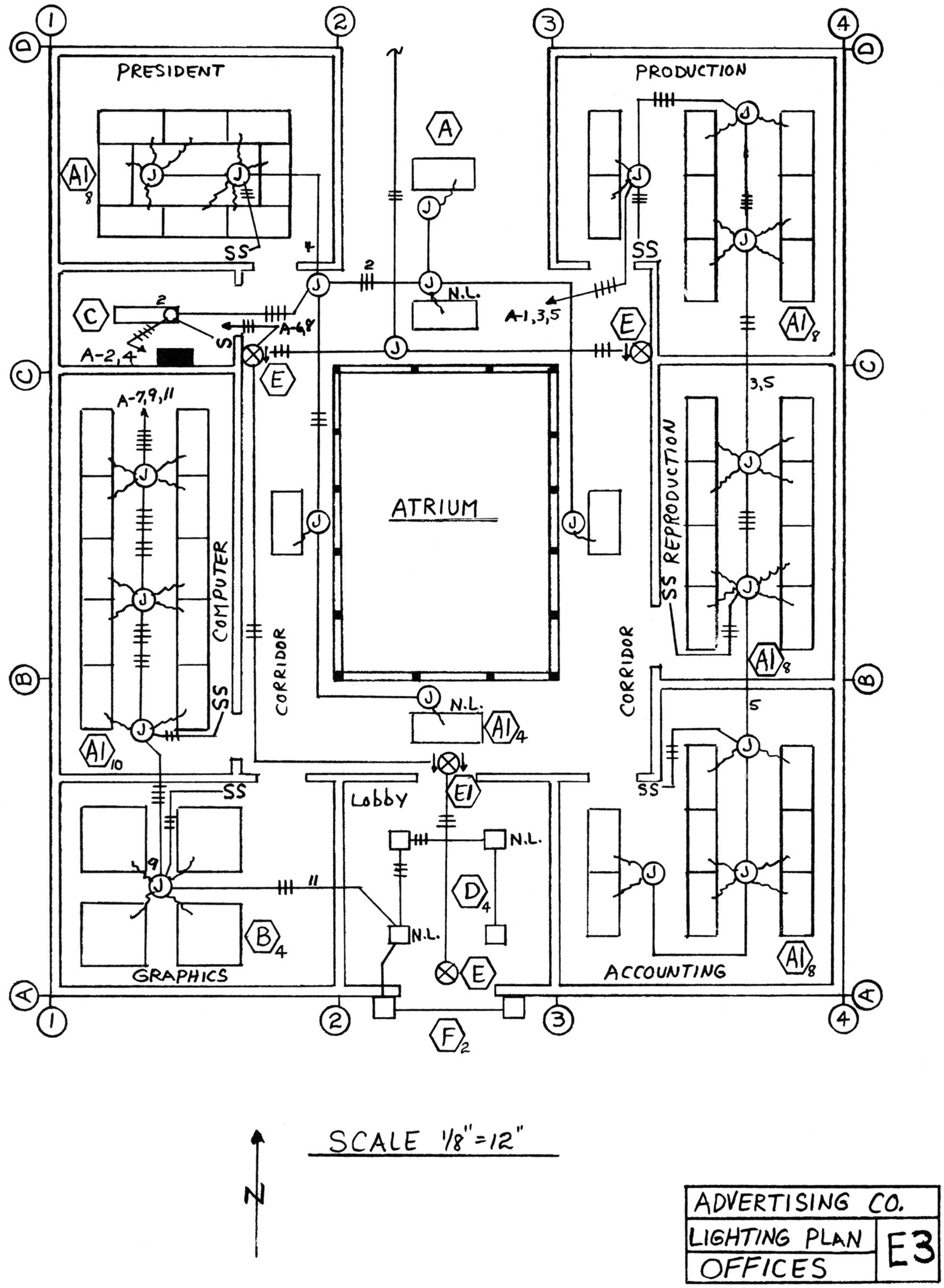
Electrical take-offs for a small office complex (Sheet 1 of 7)

Figure 13-1



Electrical drawing — lighting plan, E3

Figure 13-2

You can do the take-off manually, of course, just by counting the numbers of each item and recording the quantity in a list. You'll find a blank table for this purpose that you can copy, Figure A1-7 in Appendix 1, at the back of this book. However, this particular take-off was done using an electronic counting tool coupled directly to the estimator's computer. When each count was completed, a single click of the tool dumped the count number into the selected cell in an Excel spreadsheet. You can generate your own spreadsheet if you're familiar with Excel. As the cells in any one item row are filled in, the spreadsheet automatically totals the number in the right-hand column. This greatly speeds the count of each item and increases the accuracy of the take-off.

Additionally, there are map measuring-type tools, such as the Scalemaster II available from Calculated Industries or the PlanWheel from Scalex Corporation, on which you can set the scale of the drawing, roll off the length of conduit or wire required on the drawing and drop that length into the appropriate cell in the take-off sheet, all with a simple click. You can find information on the Scalemaster II at www.calculated.com and on the PlanWheel at www.scalex.com.

Complete your take-off for the other electrical drawings and for all other drawings in the set for the other trades. This may sound like a lot of work, particularly if you've been used to eyeballing estimates using some simple formula based on a square footage factor, or some other estimate indicator. You can continue doing this, of course, but remember this section of the book is about thriving, not just getting by, so I urge you to get into the habit of doing accurate take-offs as the basis for your estimates. And though it may take a little while the first time around, you'll soon get the hang of it, and with practice, you'll be able to complete a take-off quickly.

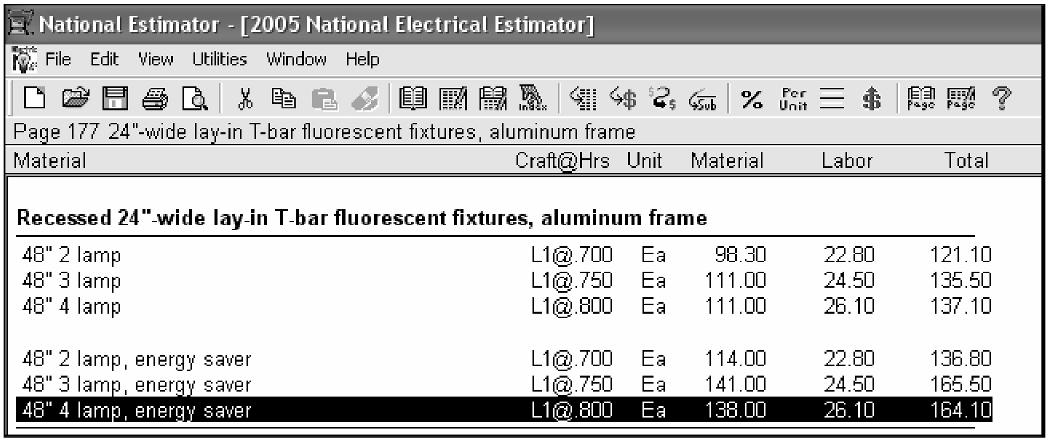
Armed with this accurate take-off, you can now start putting together your estimate.

Computer Estimating

Most building contractors have started using a computer estimating program to produce their estimates. If you haven't done so yet, now is the time to start. You're out of the financial crisis stage, you've gotten your business stabilized and you're now trying to get your business to thrive. One of the main ways to get your business thriving is to produce accurate, professional-looking estimates.

There are a number of estimating programs available today. As I mentioned earlier, one of the most widely used is The National Estimator developed by Craftsman Book Company. This software comes with a number of Craftsman books, including:

- National Concrete & Masonry Estimater
- National Construction Estimator
- National Electrical Estimator



Material	Craft@Hrs	Unit	Material	Labor	Total
Recessed 24"-wide lay-in T-bar fluorescent fixtures, aluminum frame					
48" 2 lamp	L1@.700	Ea	98.30	22.80	121.10
48" 3 lamp	L1@.750	Ea	111.00	24.50	135.50
48" 4 lamp	L1@.800	Ea	111.00	26.10	137.10
48" 2 lamp, energy saver	L1@.700	Ea	114.00	22.80	136.80
48" 3 lamp, energy saver	L1@.750	Ea	141.00	24.50	165.50
48" 4 lamp, energy saver	L1@.800	Ea	138.00	26.10	164.10

Selection from TNE electrical costbook
Figure 13-3

- National Framing & Finish Carpentry Estimator
- National Home Improvement Estimator
- National Painting Cost Estimator
- National Plumbing & HVAC Estimator
- National Renovation & Insurance Repair Estimator
- National Repair & Remodeling Estimator

I recommend that you get one of these books, because you'll need access to TNE in the following section, where I'll review the steps involved in producing a complete estimate. The CD includes a 60-minute tutorial detailing the program, so I won't go into detail here. And each book gives complete instructions on how to use the program. Let's use the example of lighting fixtures in Figure 13-1 to prepare an estimate.

Once you've got TNE set up and open, you'll see it's made up of two sections on the screen, the costbook section at the top (containing thousands of items, material and installation costs), and a bottom section into which you can paste selected items you've cut or copied from the costbook. The search box, Enter Keyword to Locate, will help you find any item in the costbook.

You know from the Specification Sheet that accompanied the set of drawings that the first item on our take-of sheet, an A fixture, is a recessed 24-inch-wide lay-in T-bar fluorescent fixture with four lamps. So, you type in the search box *fluorescent fixtures* and, having found the correct items, you'll see in Figure 13-3 that you have a choice of six different fixtures. You also have a choice of a steel-framed version, but you've decided to use the aluminum-framed type, and the energy-saver version for long-term cost considerations. You clearly need the sixth item in the list, so you highlight that line, then copy and paste it into the estimate at the bottom of the screen.

Moving to the next item A1 in the take-off sheet, which you know from the specification sheet is a two-lamp version of the same fixture, you select that item, then copy and paste again. Before the program actually adds the item(s) to the estimate, it gives you a choice of altering:

1) The quantity required (in this case 46)

2) The cost figure (if you're not happy with the cost automatically given in the costbook)

3) The manhours required to install the item

4) The manhour rate

Satisfied with the costbook figures, you click OK and the program pastes the second item into the estimate, automatically totaling the two items.

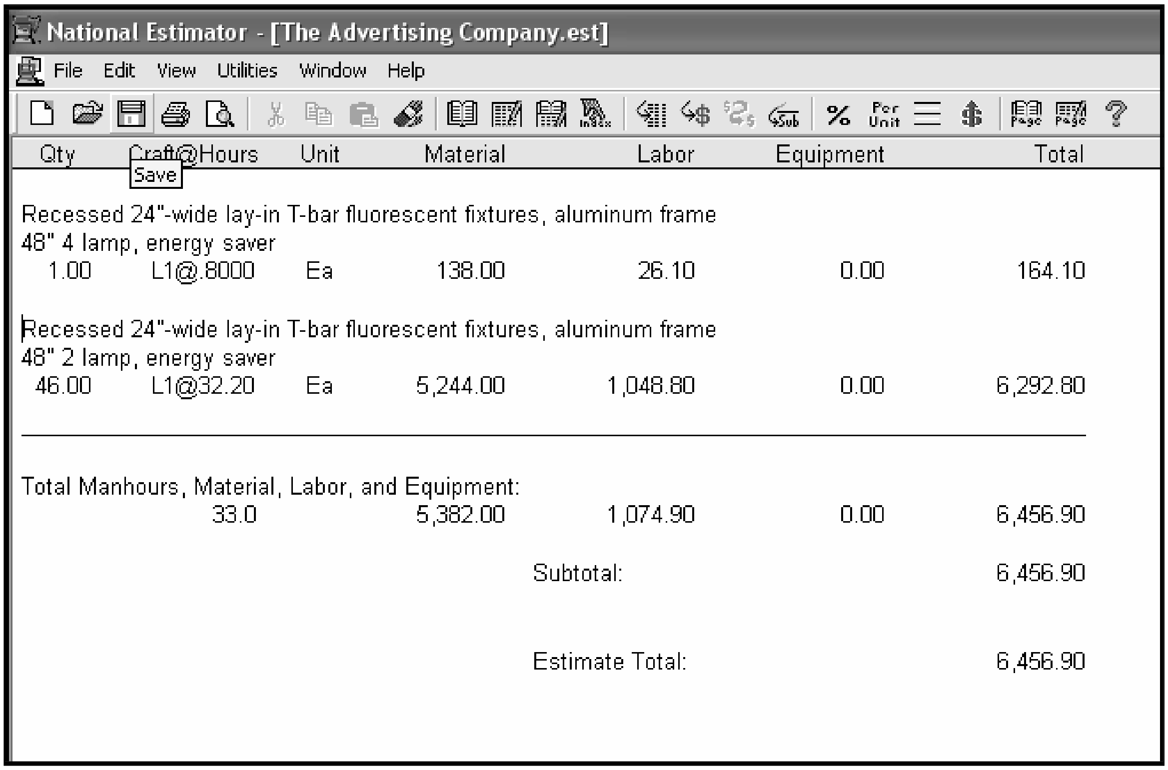
Your estimate now looks like Figure 13-4.

You continue, finding each item in our take-off list and adding them to the estimate. You have options to add costs for subcontractors' work, for any equipment used for an item's installation and for Overhead, Contingency and Profit, together termed *Mark-Up* (which we'll come to in a moment). You also have the option of adding items not found in the costbooks, and for breaking the estimate up into the various trade sections. Depending upon how much information you want to present to the customer, you can also show the marked-up material costs for every item, simply the totals for each trade section, or the sum total for everything with no details.

When you've added overhead, contingency and profit percentage, they'll be automatically distributed to each item, each trade section or the sum total figure. They will *not* be shown as individual figures in your printed estimate (you probably don't want to show your customer exactly what figures you're using for Overhead, Contingency and Profit).

Finally, the program prints out your estimate, with Company name, address, logo, etc. and the customer's information, in a presentation format to give it the professional look that you need.

This was a very brief introduction to Craftsman's estimating program, but I hope it has given you some insight into a modern estimating program. The greatest advantage is that it does the math for you, so there's virtually no chance that you'll make a calculation error. And if you follow your take-off sheet rigorously, there's very little chance that you'll accidentally leave out some item of your estimate. This type of accurate estimating is a vital component of ensuring that your business is now going to thrive.



The Advertising Company estimate (first two line items)
Figure 13-4

The estimating program also includes the ability to download your estimate into *QuickBooks Pro* (see Chapter 6), so that you can compare your estimated costs to actual costs and fine-tune the material and labor costs used in future estimates. The material costs in the costbooks are derived from national home improvement store prices and are updated frequently. Each time you sign on, you're given the option of downloading updated prices over the internet to keep your costbooks up-to-date. The manhour figures are compiled by Craftsman using a team of experts in the various building contracting trades. If your manhour costs are significantly different from those in TNE, you can easily change them, and the program will store the changes for your future estimates.

Overhead

The hourly labor rate used in the above estimate for an electrician, designated an L1, was $32.62. This figure includes the hourly wage that you're paying your electrician plus other direct overhead costs, which we'll now look at. A typical base wage for an electrician working in a construction contracting business is $24.34 per hour for our purposes here. So, let's look at how a base salary of $24.34 per hour ends up costing you, the employer, $32.62 per hour. The difference is known as *direct overhead*.

Direct Overhead

Direct overhead, also referred to as *labor burden*, includes additional costs involved in employing labor, other than the employee's actual wages or salary. These include:

Fringe Benefits — Fringe benefits include vacation pay, sick leave and other taxable items. Fringe benefits typically average 5.15 percent of base wages for many construction contractors. This benefit is in addition to the basic wage you're paying your employees.

Insurance and Employer Taxes — Insurance costs includes workers' compensation, contractor's casualty and liability insurance and unemployment insurance. Rates can vary considerably from state to state, by type of trade (roofers carry a higher workers' compensation rate than secretaries, for instance), and also can depend upon the contractor's loss record. Insurance and employer taxes add between 23 percent (electrician) and 41 percent (roofer), generally averaging about 30-35 percent. In the example above, the taxes added for your electrician are 23.15 percent. Also included in these costs are Social Security and Disability Insurance, known as FICA. FICA is the only one of these costs to which your employees make a contribution.

"...the actual cost of employing an electrician is about 34 percent greater than his actual wages."

Medical and Pension Costs — These costs include the employer's contribution to medical insurance, tax-deferred pension plans, such as 401K plans and profit-sharing plans. These benefits average an additional 4.55 percent of base wages for many construction contractors.

So, let's see how all of this adds up for your electrician employee. The numbers will vary, of course, for all the other trades, and detailed costs can be found in any of the previously mentioned National Estimators.

Electrician's Hourly Wage	$24.34
Fringe Benefits @ 5.15%	$1.25
Insurance and Employer Taxes @ 23.15%	$5.92
Medical and Pension Costs @ 4.55%	$1.11
Total Hourly Cost	**$32.62**

Understand this very clearly. None of these additional costs are paid by the employee. He does make a contribution to FICA, but his contribution isn't included in these costs. The money for these additional costs has to come out of your checking account every quarter. So the actual cost of employing an electrician is about 34 percent greater than his actual wages. And there's no legal way to avoid paying this labor burden in full. States and the federal government impose heavy penalties on employers who don't make their quarterly deposits on time or fail to provide compensation insurance.

Indirect Overhead

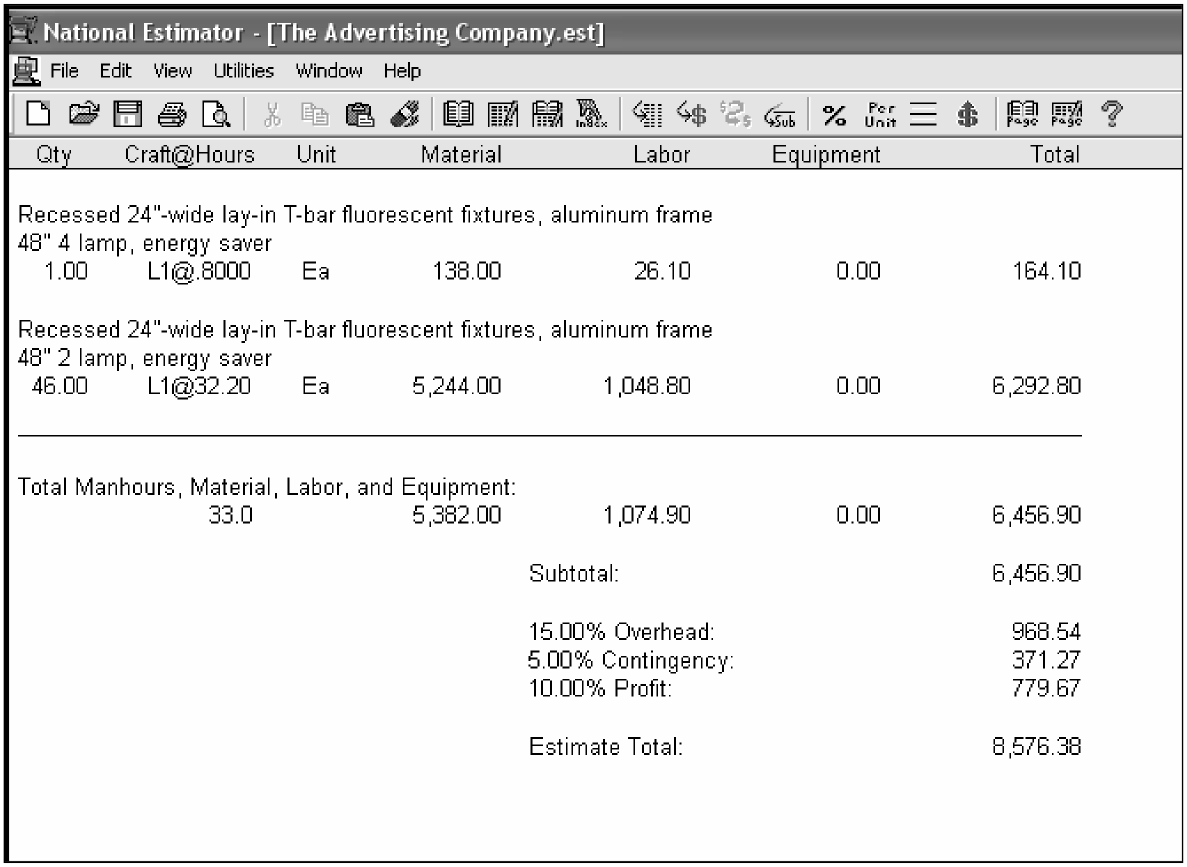
Indirect overhead is quite a different matter, and is the overhead that's referred to in our estimate above. This includes all costs of doing business other than paying your on-site employees and their attendant benefits, etc. You still have indirect overhead costs even if all building work stops and you have no on-site wages to pay. These costs are administrative or office expenses that exist just because you're in business — accounting fees, advertising, automobiles, depreciation on vehicles and equipment, donations, dues and subscriptions, entertaining, interest, legal fees, licenses, maintenance and repairs, office insurance, office phones, office rent, office staff salaries and benefits, office supplies, office utilities, payroll taxes, pensions, postage, profit-sharing, small tools, taxes (property and business income), travel and uncollectibles.

There are usually other indirect overhead costs in the General Conditions of a contract that have to be included somewhere. They can either be added to the indirect overhead expenses list above or added as separate items to specific estimates if they only occur on certain jobs. It's entirely up to you where you include them, but these are real costs, some on all jobs and others just on certain projects. The ones that you chose not to include in your total indirect overheads cost list you *should* include in a separate list, and pin it on the wall over your computer to remind you to include them in specific estimates, when necessary.

These include costs that aren't generally associated with any trade or installed material. Instead, they may be the direct result of taking on a particular type of job — barricades, special bonds (maintenance, street repair), building permits and fees, clean-up, design fees, job shack, port-a-potty, job signs, protection during construction, repairing damage, sewer connection fees, street closing fees, surveying, temporary fencing, temporary utilities (phone, water, electricity), watchmen and water meter fees.

Estimating your indirect overhead rate is obviously more difficult than your direct overhead rate — but you generally only have to do it once a year, unless your business circumstances change dramatically and you need to do a recalculation. The best way to proceed is to make two basic calculations or educated guesses. First, what's the total cost of your administrative or non-job-specific overhead for the coming year? You should be able to do a pretty good estimate of this figure. If you're in doubt, go back through your records for the previous year. Add up all the indirect overhead costs for last year and then adjust that figure up or down to reflect anticipated higher or lower costs for the coming year.

Second, forecast the gross volume of business you expect to do in the coming year. Be realistic. It's better to under-forecast than over-forecast. When you have these two numbers, divide the total indirect overhead cost by the gross volume forecast figure, and then convert it to a percentage by multiplying by 100. If you're like most general contractors, you'll get a number between 12 and 18 percent, averaging out at about 15 percent.



Qty	Craft@Hours	Unit	Material	Labor	Equipment	Total
Recessed 24"-wide lay-in T-bar fluorescent fixtures, aluminum frame						
48" 4 lamp, energy saver						
1.00	L1@.8000	Ea	138.00	26.10	0.00	164.10
Recessed 24"-wide lay-in T-bar fluorescent fixtures, aluminum frame						
48" 2 lamp, energy saver						
46.00	L1@32.20	Ea	5,244.00	1,048.80	0.00	6,292.80
Total Manhours, Material, Labor, and Equipment:						
	33.0		5,382.00	1,074.90	0.00	6,456.90
				Subtotal:		6,456.90
				15.00% Overhead:		968.54
				5.00% Contingency:		371.27
				10.00% Profit:		779.67
				Estimate Total:		8,576.38

Advertising Company estimate including overhead, contingency and profit
Figure 13-5

Subcontractors may run a few percent lower, while remodelers and insurance repair contractors may be a few percent higher. When you've established that percentage figure, include that number on the Overhead line in Figure 13-5. For our example, we'll use an overhead figure of 15 percent.

Contingency

Contingency is there to allow you to include some monies to cover such things as errors in your take-off, unanticipated weather delays, labor strikes or whatever that you've no other way of allowing for, other than to throw in a small amount to cover those possibilities. The number you add here can be a fixed dollar amount or a percentage of the costs up to this point. It's fairly common to include a 5 percent to 10 percent contingency although, of course, this will increase your bid amount and will make you less competitive. Again, it's a matter of judgment whether or not you need such contingencies and whether or not you can afford to include them and still get the contract. It's not unusual to include a figure of 2 to 5 percent to cover contingencies. We'll use a figure of 5 percent in our example.

Profit

Profit is another topic about which whole books are written, but we clearly don't have enough space to go into all the considerations here. The whole purpose of being in business is to make a profit, not just to pay yourself and your partners (if you have any) a salary out of the business. Your salary and your profits are two entirely different matters. Yes, of course you need to pay yourself a salary out of the money the business makes, but the business also needs to make a profit on top of that to fund future projects and to expand the business — to *thrive.*

Maximizing profit is a whole study in itself — *is it better to make a small profit margin on a high volume of business or a high profit margin on a small volume of business?* The end dollar result may be identical, but the route you take may be very different. Clearly, the profit margin percentage you choose to apply will depend upon the volume of business that you can reasonably expect, so you need to be very realistic about this. A low volume business with a low number of sales per year (like selling Jaguars for instance), needs a high profit margin on each sale to thrive, whereas the supermarket business with enormous volume and high sales per year does very well on low profit margins, often in the low single digits. But the hours required are very different! The number of sales per year is the total revenue for the year divided by the average amount of inventory (i.e. how many times per year you sell the total volume of inventory).

"Maximizing profit is a whole study in itself..."

So how do you decide what profit margin percentage figure to apply to your estimates? You'd like to use as high a figure as possible, but since this figure multiplies all of the costs in your estimate, too high a figure will probably make your bids too high to get any contracts. Of course, if you use too low a figure, you may get lots of contracts, but leave a lot of money on the table.

What most contractors do is start with a figure of 10 percent and see how it goes. If you're continually being underbid, it could be due to a number of factors. Perhaps your operation isn't very efficient, you're not very accurate in your estimates, your competitors are poor estimators, business is very light at the moment or any number of other factors. If you're running an efficient operation, your estimates are accurate but there are only a few bidders, then perhaps you'll need to lower your profit margin somewhat to get business.

On the other hand, if you're winning more contracts than you can handle, you're probably using too low a profit margin percentage and you can afford to increase it. Since profit is the name of the game, even if you're using a fairly high profit margin percentage and still getting plenty of contracts, you should increase it some more until you get to win the number of contracts you can comfortably handle.

It's clearly somewhat of a juggling act, so don't consider your profit margin percentage to be set in stone. Adjust it to take into account the current business climate and the number of competitors, etc. If you can keep your profit margin greater than 10 percent on a consistent basis, you'll be doing very well. However, when the figure starts to fall to the low single digits, you may need to consider moving on to a different market, as we discussed at the beginning of this chapter.

So, having settled on starting figures of 15 percent for indirect overhead, 5 percent for contingency and 10 percent for profit, let's see what our estimate example now looks like, in Figure 13-5.

You'll notice, if you check the math, that the overhead, contingency and profit are cumulative — the overhead is applied to the Subtotal, the Contingency is applied to the Subtotal plus the Contingency, and the Profit is applied to the Subtotal, plus the Overhead and the Contingency.

Finally, print our example estimate, using your company information (the Twice Right Construction Company for now), and the client's information. There are print-out options to show all the material costs and mark-up information or to apportion the mark-up to each item (so that the customer doesn't see what mark-up figures you're using). Since this is the most common practice, we'll use it in our final estimate, in Figure 13-6.

Financing and Carrying Your Client

Few small-volume builders have enough cash reserves to carry a construction project for very long without progress payments from the client. If you're like most builders, your finances are so thin that clients usually have to carry you financially. Some clients don't mind advancing cash on a project. Others are willing to do it but make you pay through the nose for the privilege.

A client who's prepared to meet your accelerated payment schedule probably wants to pay the lowest possible price in return. That type of work usually doesn't generate much profit. Without adequate profits, you can't build cash reserves, forcing you to take more low-profit work. It's a vicious circle that you have to find a way to break out of — if you can't, you're just selling hours for money and you should go get yourself a job.

Profits are the lifeblood of a construction company. You take big risks as a builder. You have big expenses. It's only fair that the potential reward should be as big as the risk. You need to make adequate profits. Without them, you're stuck in low-profit work. It's just a matter of time before a miscalculation or an economic slump pushes you into financial crisis.

Profits finance growth. They allow you to tackle larger and generally more profitable projects. The larger the project, the greater the potential reward, but the more cash you need in reserve.

Twice Right Construction Company

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GCC-1234

Estimate

Date	Estimate #
4/26/2006	1
Customer	**Job**
John E Doe	Office

Customer Information
John E Doe The Advertising Company 23456 Nowhere Ave Everywhere, CA 99999

Description	Qty	Rate	Amount
Recessed 24 in.-wide lay-in T-bar fluorescent fixtures, aluminum frame. 48 in. 4 lamp, energy saver			
1 Ea			
Recessed 24 in.-wide lay-in T-bar fluorescent fixtures, aluminum frame. 48 in. 2 lamp, energy saver			
46 Ea			
Project material, labor			
Material, per job	1	7,148.64	7,148.64
Labor, per job	1	1,427.74	1,427.74
________________			
Project Subtotal			8,576.38
Project Total			8,576.38
		Total	8,576.38

Print-out of example Advertising Company estimate

Figure 13-6

Sometimes you'll have to carry the job and your client longer than you expected. Every client has his own idiosyncrasies. Some pay faster than others. It's hard to tell in advance which clients will pay upon presentation of an invoice and which will pay 30, 60 or 90 days later. The best clients with the deepest pockets don't always pay promptly or in the amount expected.

Sometimes you're not going to get paid when you expected according to your cash flow projection, especially if the project is behind schedule. For example, a shortage of some key material, a labor dispute or a string of weather delays can push back a progress payment date by weeks or even a month.

Some clients will intentionally try to get you behind the eight ball financially. It saves them from paying interest on loans they would otherwise have to take out. It's up to you to keep your clients on a short leash. Don't carry a client for more than 10 percent of the job cost, or for more than 90 days. A client who needs more support than that is taking advantage of you.

Watch out for clients who play the leverage game. They'll get you in the hole for $50,000 or so if you let them, and keep you there after the job completion date. This puts them in the driver's seat if repairs are needed during the guaranty period. They can get you back to fix things quickly if they're holding a large chunk of your money.

The fact that a client delays payment for 30 to 60 days shouldn't create panic in your office, if the amount due doesn't exceed about 5 percent of the total project value. But holding 10 percent or more for 90 days should set alarm bells ringing.

One exception you should consider favorably is the client who wants to delay payment until January 1st or July 1st to get the payment into a new fiscal year. Many corporations have fiscal years that start on the first day of months other than January or July, so it pays to know just what fiscal year your client's company operates on. It's not unusual to avoid a January to December fiscal year to eliminate the crunch over the holiday period. I've permitted clients to delay payment for a short period to get the payment in their next fiscal year, provided the client informed me beforehand and then made the payment when promised.

Since there's no way to avoid carrying a client occasionally, you should have an emergency plan when the situation arises. If you suspect you're going to have a payment problem, bring your banker into the picture early, as you may need to take out a short-term loan. Bankers hate surprises and like to take their time evaluating loan applications. If you need to take out a loan for a short period, it's going to cost you money you hadn't planned on, which should be charged to the client. Don't forget to discuss any such charges with your client before sending him the bill. These costs are a part of doing business. Your client should be prepared to pay. Payment problems are one of the main reasons for having a watertight contract (see Contracts later in this chapter).

Many construction companies arrange lines of credit with a bank. A credit line is like a pre-approved loan. Get the line of credit approved first, then you can borrow when you need to and only as much as you need. Repay the amount and you re-establish the credit line at the original figure. The interest rate will usually vary as the prime rate varies.

Bankers love a contractor who gets a job, takes out a loan to finance it, keeps to an agreed build timetable, collects his progress payments regularly, makes his monthly loan payments, finishes the job on time, pays off the loan on schedule and moves on to the next job. A builder who can do that regularly is considered an ideal customer at any bank.

Scheduling

There are only two construction schedules that make any sense: *Fast* and *Faster*. Allowing a job to drag on longer than necessary can lead to a number of problems. It can run up construction costs, increase losses due to inclement weather, encourage pilferage, force the transfer of crews and equipment between jobs and, especially, make collections more difficult.

A well-controlled effort is the primary characteristic of a fast-paced contractor. Each subcontractor is notified of the start and completion dates and has an incentive to meet those targets. Bonus clauses and penalty clauses encourage prompt performance.

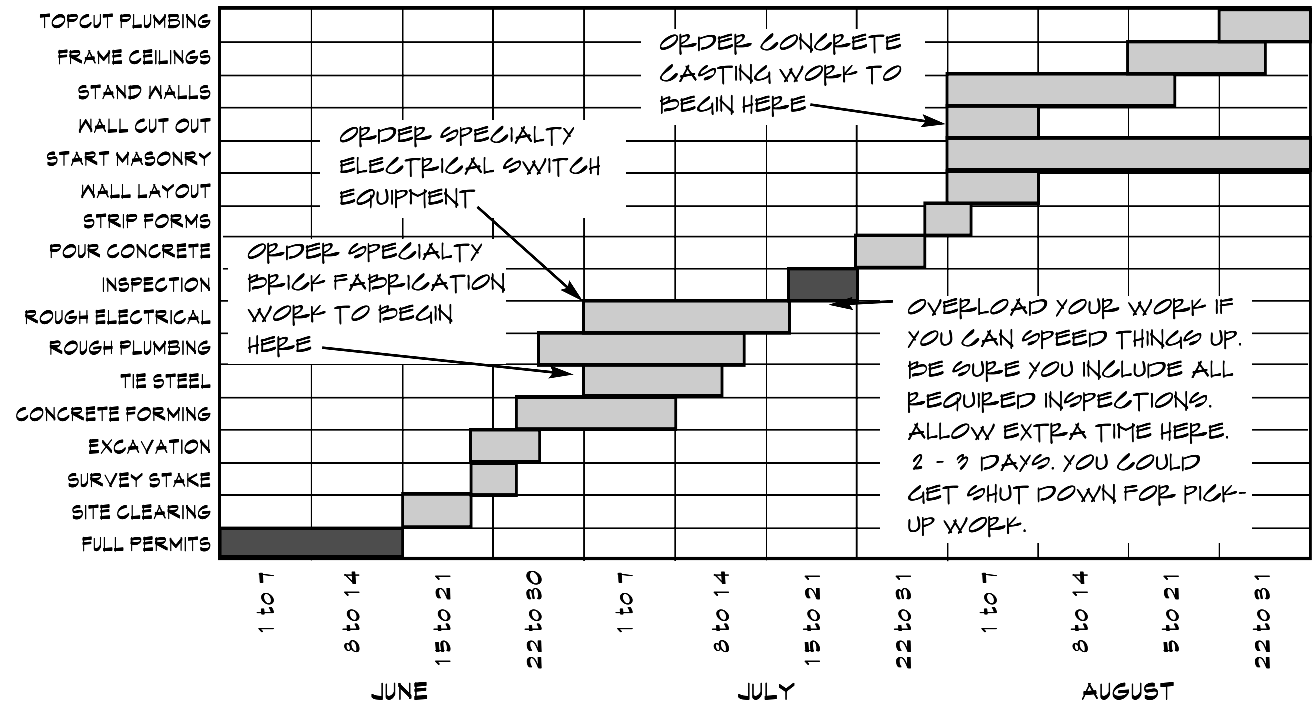
A fast-paced schedule should include specific building department inspections and certifications.

The schedule should consider the owner's needs, the advantages of early building occupancy and special equipment installations. Figure 13-7 shows a three-month schedule from start to finish, prepared using a scheduling chart based upon Microsoft Excel's spreadsheet program. The only thing a fast schedule doesn't fully address is the early ordering of equipment and materials. It assumes that the job is awarded to the lowest bidder and that time isn't truly critical. Equipment and materials can be purchased and shipped as they're needed.

Scheduling a job where time is a high priority is usually done using a proprietary scheduling program. There are many general project scheduling programs available, such as Microsoft's Project. A quick search on the internet, by entering *task scheduling software*, will reveal a selection of software packages. One that's specifically designed for building contractors is *VirtualBoss*®.

VirtualBoss is an easy-to-use job scheduling and task management software package designed for contractors by contractors. It streamlines your scheduling and job management functions and operates on any Windows-based PC, including desktops, laptops, Pocket PCs, Tablet PCs, stand-alones,

TYPICAL PROJECT SCHEDULE

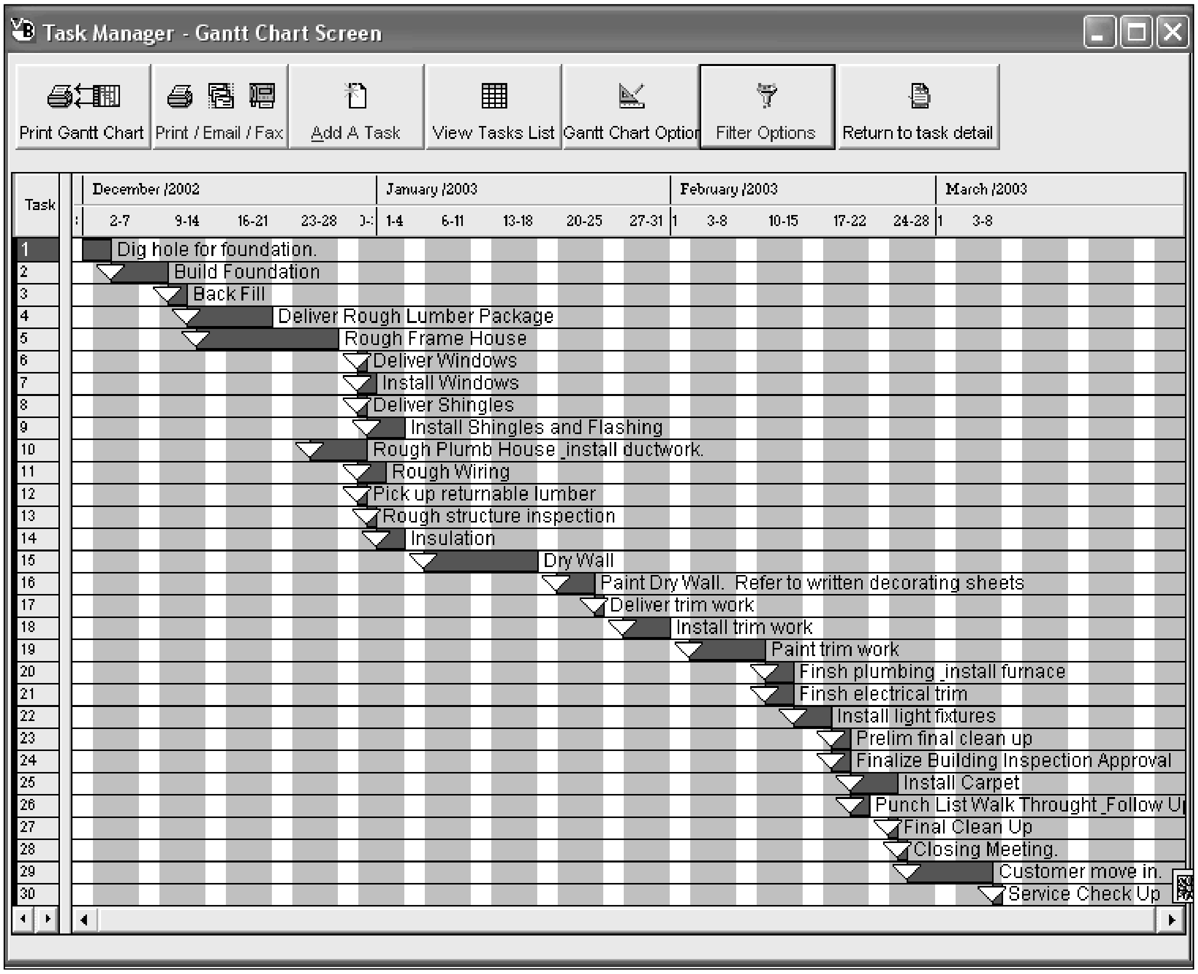


Typical project schedule
Figure 13-7

and networks. The program gives you the exact status of your project and task list at all times, and also keeps track of the big picture for you. Punch lists, service calls and to-do items won't be forgotten or fall through the cracks — enter customized job data once and it's automatically reflected on all reports. Your entire schedule can be updated by changing a single task. A typical Gantt chart generated using VirtualBoss is shown in Figure 13-8.

There are other software programs included that show which tasks must be done first, second and third, what materials have to be ordered at what time and when delivery is required. The VirtualBoss software package can also interface with *QuickBooks Pro* to share information with your bookkeeping software.

The other approach to scheduling is a *faster-track* schedule, though it requires considerable trust and cooperation between builder and owner. A faster-track schedule has one major advantage. It gives the owner and the builder the opportunity to order materials and complete certain tasks before the final construction contract is signed and before all the plans are approved by the local building department. Pre-ordering can substantially reduce project duration, especially if major pieces of equipment have to be



Gantt chart project schedule
Figure 13-8

custom-built for the job. But it drives architects and engineers crazy. They have to set their final designs early and prepare several smaller sets of drawings for grading, steel, plumbing, sewer and power distribution. It's far more work for them, but can be a definite advantage for everyone else, if early occupancy is a pressing consideration.

Under the faster-track schedule method, the architects and engineers prepare a grading and site preparation plan that stands on its own without reference to any other drawings or documents. This plan is submitted for building department approval and released to the owner and the contractor before the other plans are ready for checking or bidding.

The foundation plan is prepared next. It's a separate project that can be scheduled and checked without referring to any other part of the job. Once the foundation plan is approved and construction begins, there's no turning back. All of the building must now conform to the foundation shape and the maximum design weight. Changes made after the foundation is complete become very expensive.

Faster-track schedules can take their toll on everyone involved and should not be your standard building method. But they do have their place when time is of the essence. If you consider using a faster-track schedule, particular care needs to be taken in writing the project contract, as you're committing yourself to ordering material and possibly expending a significant amount of labor prior to all of the permits and drawing packages being complete. Make sure that any work that has to be undone or redone due to permit or drawing changes comes out of the owner's pockets and not yours.

Contracts

Again, this is one of those topics that could fill an entire book, rather than a single section of one chapter, so we'll just deal with the highlights and refer you to the best sources of information on this topic. A contract must spell out the responsibilities of each party. Avoid surprises and you'll stay out of court. Be sure the contract covers the important points — what's to be done, by whom and when.

Every contract should have a start and finish date. When do you begin and when do you plan to finish? What happens if you finish early or late? What are the incentives and penalties? Naturally, the contract should excuse any "force majeure" delays (such as a labor strike, extreme weather and other Acts of God). If you haven't considered all of these things, you don't have a very complete contract.

Set up a procedure for handling extras. Don't specify that the cost of extras will be "cost plus 10 percent." Instead, include the cost of labor, materials, equipment, overhead and the contractor's usual profit for extras.

"Naturally, the contract should excuse any "force majeure" delays (such as a labor strike, extreme weather and other Acts of God)."

Be sure to incorporate the plans and specs into the contract by directly referring to them. Include the legal description of the property in the contract. You're encumbering legal title of the property with your work. If you have to sue, you want to cloud title to the right parcel.

Preventing collection problems is one of the main reasons for having a watertight contract. Make sure your contract gives you the right to charge interest on unpaid balances and provides reimbursement for legal fees if professional collection is necessary. Craftsman Book Company publishes several books with information on how to reduce the risk of collection problems. See the order form at the back of this book for titles and book descriptions.

Summary

For builders who have to survive on the lowest bids, general construction contracting can be war — with few survivors. Either try to find a way to negotiate jobs at fixed fees or find a specialty with less competition. Don't bid jobs that have dozens of bidders. Your chances of being awarded the contract are miniscule.

If you're not proficient at estimating, take the time to master this skill and invest in a good estimating program. *Make estimating your strong suit.* Many schools teach construction estimating and several helpful references are listed in Appendix 4. There's no good substitute for being thorough — doing an accurate take-off identifying every part of the project and then doing a detailed estimate with the material, labor, subcontract and equipment costs of each part. And be sure to include all taxes, insurance, overhead, contingency and profit.

Remember my rule of thumb for carrying a client. *Never carry a balance due beyond 90 days and never advance more than 10 percent of the project cost.* Beyond that only fools venture.

Run projects at a controlled sprint. Start a job, work hard, finish it and move on to the next one. Work three jobs, one at a time, not three jobs working all three at the same time. Invest in a good scheduling program and become an expert in using it. Remember my advice: It's not buying the exercise equipment that gets the weight off and the muscles on, it's using the equipment. The same goes for any program you purchase, whether it's for bookkeeping, estimating, scheduling or contract writing.

Finally, make sure you have a watertight contract for each project. It's difficult to think of every problem that can occur on a building project, especially when you're just starting out in your business. So, rather than learning on the job, which can be very costly and even fatal to your business, invest in a good contract-writing package and use it.

Investing in Inflation

As a construction contractor, there are two ways to measure your success. First, do you get personal satisfaction from your work? Second, are you making good money as a contractor? Not only are you able to take a good salary out of the business, but is the business also making a good profit? Generally, the answer to the second question influences the answer to the first. If you're able to take a good salary, you have personal satisfaction. And profits tend to breed more profits. Many contractors multiply their profits by investing in inflation and betting on appreciation. This chapter is intended to explain how they do it.

Profits give you money to invest. The more cash you have on hand at the end of each project, the more you can invest. Spread your profits across well-chosen real estate, mix in a little inflation or appreciation and the result can be pure magic.

Many builders make good money in construction. But the most successful construction contractors also make money by investing in land and buildings — subjects builders know intimately and can evaluate accurately. If you're interested in building net worth (and who isn't?), your profits serve two purposes. First, they're a source of excess cash that can be used for investment. Second, they're a stream of future income that qualifies you as a lender when buying or developing more property.

As we discussed in an earlier chapter, the serious money in construction is made by project owners. Look at Figures 11-2 and 11-3 back in Chapter 11. What's happening here? It's money working, invested capital — not the time or labor of the investor. That's why failing to make a decent profit on each job hurts twice: Once for the cash you didn't make and once for the investment opportunities you had to pass up because you didn't have the cash available.

Profits are your ticket to the high-stakes inflation and appreciation game. If you're not making extra cash from inflation, you're missing the boat. While inflation may not go on forever, it's been very persistent for the last 50 years. The next 50 years will likely be the same. Maybe it's built into the economic or political system in this country or the world. Maybe it's the result of some phenomenon we don't understand. Maybe it doesn't matter; the important thing is that it exists.

Sure, inflation may ratchet down to 2 percent or less. But it has always cycled back up again to higher levels within a few years. And inflation in property prices has nearly always outstripped the inflation in the general economy.

Buying and Investing in Property

Here's my advice on buying land and planning projects. *Don't buy anything unless you have the cash to develop it and know how it can best be developed.* Only buy raw land that you plan to build on fairly soon. Holding raw land has no tax advantage beyond the interest you pay on any loan. Don't buy properties with heavily negative cash flow. You have enough drain on your time, energy and income without supporting underproductive property. Buy inexpensive but well-located property. Look for buyers anxious to sell. Make a number of offers at 10 or 20 percent below the asking price, and one will probably be accepted. Buy because the price is right, not because you love the property.

As a builder, you know what property is worth and which areas can be developed profitably. Evaluate any property you're contracted to build carefully. You know what the asking price of the land is. You know the cost of construction and the selling price for houses in that area, so it's easy to figure out what the owner's profit will be on an eventual sale. Where property developers are making good money building for sale or rent, you can do the same. You can *be* that owner. You're already in the position of being one of the most knowledgeable people in your area on land values and spec building opportunities.

If there aren't any real opportunities in your back yard, by all means look elsewhere. Use the services of a Realtor, if necessary. But the Realtor's fee will increase the overall cost. Whenever possible, find your own property. Keep the profits in your pocket. *Don't pay others to do what you can do yourself.*

Trading Property

Most property that changes hands will involve a buyer and a seller. But experienced real estate professionals and knowledgeable investors have discovered the advantages of *trading* real estate rather than selling it outright. During a recession, trading can become the norm rather than the exception for many builders and Realtors. When done correctly, trading avoids capital gains taxes while allowing the new owner to begin depreciation of the property at the new value.

PROPOSED AUTOMOBILE DEALERSHIP BUILDING

ITEM		$
1	COST OF LAND	$370,000
2	ARCHITECT AND ENGINEERING FEES	$58,000
3	**OWNER'S UPFRONT COSTS**	**$428,000**
4	COST OF CONSTRUCTION INCLUDING CARRYING COST AND PROFIT	$1,210,000
5	OWNER'S CASH INTO PROJECT	-$472,750
6	**BALANCE BEFORE OWNER'S BANK LOAN**	**$737,250**
7	MAXIMUM BANK LOAN OBTAINABLE BY OWNER	-$650,000
8	INTEREST ON LOAN, 6 MONTHS @ 7%	$22,750
9	**REMAINING CASH REQUIRED OR DEAL FALLS APART**	**$110,000**
10	YOU DECIDE TO PUT UP YOUR PROFITS TO COVER THIS SHORTFALL	-$110,000
11	**BALANCE REQUIRED**	**$0**
	NOTE: TOTAL COST OF PROJECT 1 + 2 + 4 +8 = $1,660,750	

Profit investment deal
Figure 14-1

There are two basic kinds of trades in the real estate industry. *Sweat equity trading* is by far the most common and easiest to transact. The second is known as the *tax-free exchange*. Let's look at sweat equity trades first.

Sweat Equity Trading

Equity is the value of the property after all loans or liens have been paid off. If a home is worth $200,000 and the existing loans total $180,000, the equity is $20,000. But if the owner remodels the basement, paints the exterior and adds a porch (adding $20,000 to the value of the property), his equity will increase to $40,000 because the value of the home now becomes $220,000. The $20,000 increase is the result of his effort, not a reduction in the loans outstanding. Hence the name, *Sweat Equity*.

But sweat equity isn't limited to homeowners improving their own homes. Professional builders can get in on the act, too. It's building sweat equity when you trade your services for an equity position in real estate. Here's an example: A developer in your community is planning to build a new car showroom on some land he's just purchased and lease it to an auto dealership on a long-term basis. He's asked you to bid on the job. After reviewing all bids and changing the design several times, the owner realizes that he hasn't got enough funds to complete the deal. The financial details are shown in Figure 14-1.

This chart shows that the owner is $110,000 short of funds needed to complete the project. At this point, one of several things will happen. Usually, the project dies and never gets built. Or the owner might be able to bring in another investor with $110,000 and give him a stake in the finished project. But there's another option. You had expected to make $110,000 profit on this job if your bid had been accepted. You had estimated the cost of the project at $1,100,000 plus a 10 percent profit (a total cost of $1,210,000). You offer to reduce your bid by $110,000 in return for an $110,000 stake in the showroom. If that's acceptable to the bank, it may be an excellent deal for you. *You receive a share of the rent each month and cash out when the property is sold.*

Note that your investment of $110,000 has just bought you a 6.6 percent stake in the project, and at an inflation rate of only 5 percent your $110,000 investment will grow to $179,200, an increase of $69,200, over 10 years. If you divide $69,200 by your $110,000 investment, you've increased the value of your asset by 63 percent. If you hadn't loaned your profits, you would not only have lost the $69,200 growth but also the original $110,000 profit on the job as well (as the project would probably have died), for a total loss of $179,200 in profits.

Here's one note of caution. Don't loan your overhead, in addition to your profit. Your office staff wages, rent, phone, gas and utility bills all still have to be paid. *Only invest your anticipated profit, but don't go beyond that.* Cover all your costs, including overhead, contingency and salary for your time. Investing more than your profit is the quickest way possible to go broke.

And don't invest $110,000 with just anybody. Evaluate the stability and suitability of the developer as a partner. Check his credit, insist on references, talk with his attorney, investigate his banking connections and review his financial statements for the past five years. Consult with your own attorney to make sure you haven't forgotten anything. If the developer checks out OK, take a chance. It's a good piece of business that you wouldn't have gotten otherwise, and it should become a good investment, too.

This type of deal is only as good as the investment itself. Be sure the proposal is sound and that there's a way out. Your interest may be hard to sell by itself if the property isn't sold as a whole, *so cover yourself with a buy-sell agreement or form a limited partnership that will actually own the property.*

Tax-Free Exchange

The second trading method is known as a *tax-free exchange*. It's a little more complicated. A tax-free exchange postpones income and thus postpones payment of taxes. A tax-free exchange is like any other purchase and sale except that no money changes hands.

Here's how it works. Let's say that you've owned an apartment building for several years. It's appreciated in value and your equity has grown considerably, but now you want to sell for two reasons. First, the annual tax deduction for depreciation and interest is a small fraction of the deduction that was available when the building was new. Second, you now have the cash available to buy a larger apartment building.

Your accountant calculates that you'll owe a big chunk of capital gains tax if you sell the apartment building now. You want to sell it, but you don't want to hand a lot of the appreciation to the IRS. Consider a trade. It will both preserve your profit and delay paying the tax.

First, find a willing buyer for your apartment building. Open escrow or sign a sales agreement with that buyer. Now, go shopping for a new apartment building you want to buy. That's right — you also have to become a buyer if you want to avoid paying capital gains taxes.

Shop around for a larger apartment building that you'd like to own. Inform the buyer of your apartment building which property you've chosen to buy. Your buyer then contracts to buy the new property you've located. At this point, two pieces of real estate have been tied up — the one you presently own (and have decided to sell) and the one you'd like to own.

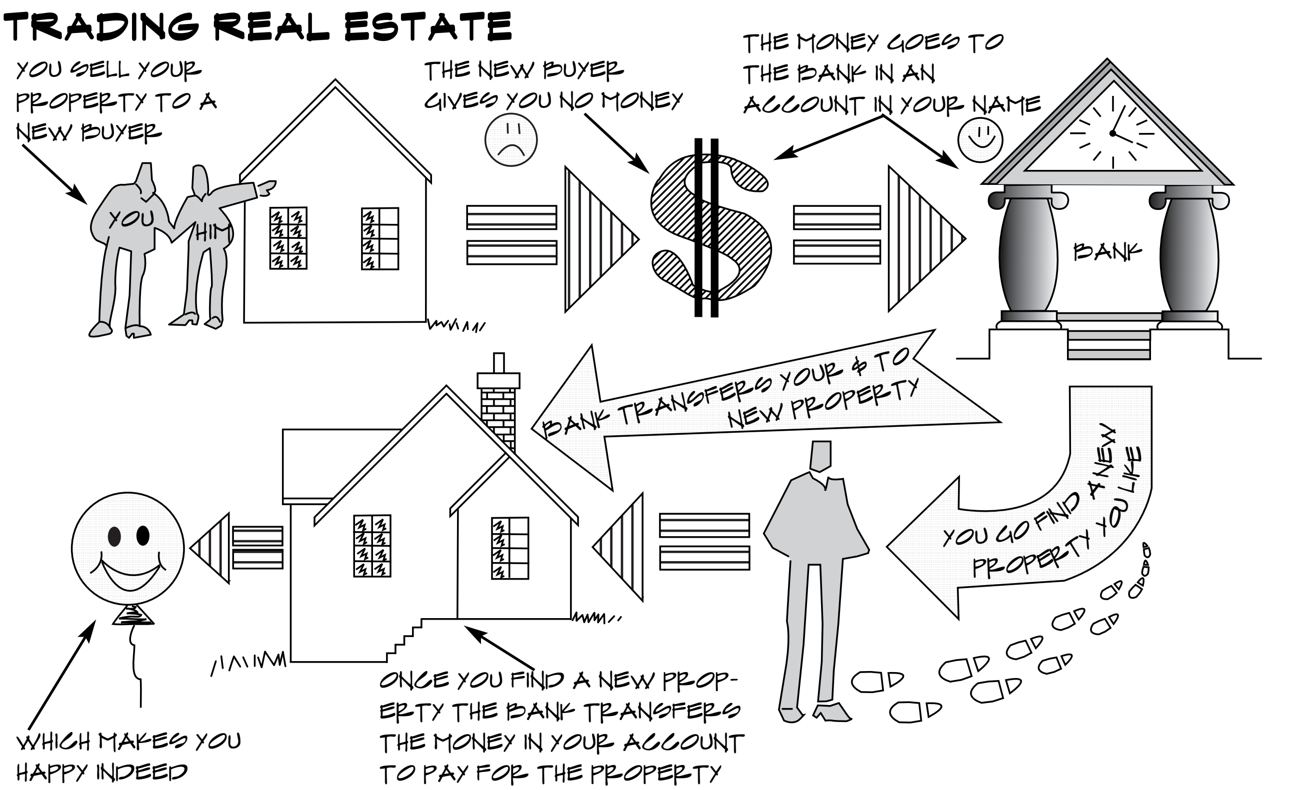
Now the magic takes place. The buyer of your apartment building uses his cash to buy the property you want. Next, he instructs the escrow company to trade the newly purchased property to you for the property you already own, thus completing the transaction. To qualify for deferral of capital gains tax, such exchanges must be done in accordance with section 1031 of the Internal Revenue Code, so be sure to get good tax advice from your accountant or a tax specialist before contemplating a tax-free exchange.

What you've done is a simple trade. You've traded your real estate for your buyer's real estate. Figure 14-2 outlines the procedure. Keep in mind that the trade has very rigid time requirements. You must acquire your replacement property within 180 days from closing the first sale, or by the due date for your tax return for the year of the sale.

As soon as you own the new apartment building, you can begin depreciating it all over again. That's a big advantage if the property you traded away had been fully depreciated. Also, the exchange may involve a refinancing of the property, giving you spendable cash when the trade is complete.

On the negative side, tax-free exchanges are cumbersome, time-consuming and may be expensive if several real estate agents are involved.

Let me emphasize that *tax-free exchanges must involve like properties* (investment property for investment property) and must always involve an increase in value.



Tax-free exchange
Figure 14-2

Of course, the capital gains tax you've deferred will have to be paid eventually. But, postponing the tax until you retire and drop into a lower tax bracket will usually cut the tax bite considerably. Also, the tax dollars you save now continue to compound, earning interest for you until some of them are finally paid to the IRS. Plus you're paying with future, cheaper dollars.

Deal Structuring and Financing

There must be ten thousand ways to structure a real estate deal. But no matter how you cut it, there's one thing to keep in mind. First and foremost, the deal must be profitable for you. If it doesn't make sense on the face of it, drop it like a hot potato. Too many tax shelter deals turn out to be investment disasters because the investor considered only the tax benefits. *If there's no profit in the deal itself, there's no reason to invest, regardless of the tax advantages.*

The next most important consideration is allowing for a profitable way out of the deal. Keeping a land deal together may be harder than keeping a marriage together. The average land transaction lasts less than five years. Every transaction should define how the deal will be dismantled if things don't go as planned. This dismantling clause should define how profits, losses and cash are to be shared or dispersed. Otherwise, the partners could be locked together indefinitely. Also, create a way for partners to sell to or buy out other partners.

The unwritten rule of premature partnership dissolution is that the partner leaving early carries the burden of his early exit. This encourages partners to see the partnership through to its original goal.

Once you've created ways into and out of a deal, pay attention to the meat of the transaction. Be sure to cover income, expenses, taxes, deductions, accounting, bank accounts and records. Once you've covered these issues, it's time to see your attorney, accountant and insurance agent.

Some of my best building contracts have been verbal deals sealed with a handshake. The total agreement is usually something like, "If you finish it by such-and-such a date, I'll pay you in full on completion." This kind of deal tends to be hassle-free, but isn't suitable for most land transactions.

"Every transaction should define how the deal will be dismantled if things don't go as planned."

The worst deals I've made have a common characteristic: bad financing. Every good deal is based on cash commitments that everyone can live with, year after year, if necessary. A bad financing package or a loan with payments you can't meet has the potential of becoming a disaster for everyone involved.

You don't need to be a lawyer to get a good financial deal. The best financing is a simple, affordable loan. Fancy terms add fancy complications. Don't try to borrow more than the 80 to 90 percent that most lenders will advance on residential property. On commercial property, you probably won't be able to borrow anywhere near as much, perhaps only 50 to 70 percent.

Where do you shop for financing? Some lenders are active and aggressive in certain areas and others are not. Lending policies vary from bank to bank. Your best bet is a lender already lending on the type of project you're planning, and is familiar with similar projects.

Investing in Your Own Projects

When you've accumulated enough in your cash reserve to begin developing your own projects, do it right. Many speculative builders skimp on the wrong things. Believe it or not, *the bulk of your profit or loss is sealed in at the planning stage of every project.* Whatever you're trying to build or develop should be well-conceived, well-planned and well-executed. Let's look at the planning of a single-family spec home as an example.

A well-conceived project starts with selecting the right building site. It also includes your selection of a house design in the selling range appropriate to the area and the curb appeal of your finished project. It also means hiring design professional and a selling agent. When you conceive a project, plan for an ultimate profitable outcome. If you ignore what your market can afford, what they want to buy, your costs and your method of sales, you're setting yourself up for an inevitable loss.

Well-planned requires forethought. Where can you best spend a few extra dollars and where can you afford to save a few bucks? These are important considerations.

Well-executed requires you to keep in mind that your job is to organize, oversee and build. You're the builder, not the designer. If it can't be done with a hammer, don't try it. Get professional help. *It's easier to hire a good architect than it is to learn to be one.* Planning pays off, so invest some money in a good plan. There are dozens of competent young designers and architects looking for a chance to do something special at a reasonable price.

"If you ignore what your market can afford... you're setting yourself up for an inevitable loss."

Ask several if they would like a shot at your project. Set up an informal contest. Contact three designers who are willing to compete for your business. Ask each to prepare a conceptual design. Explain the criteria for the job — size, floor area, site, price, materials, etc. Set a deadline for outline plan completion. Two weeks is usually enough. Have each one quote their cost to prepare a full set of working drawings for their plan. Then choose your winner and pay the losers $1,000 each for their efforts.

By the way, this type of competition works well for interior and landscape design, too.

Design Criteria

Don't get carried away with elaborate designs. Insist on a sensible and functional floor plan. There are about 25 proven, generally-accepted floor plans. For each of these basic plans, there are three or four simple variations. If you go much beyond this, you're gambling that your ideas are so red-hot they just can't fail. My advice is to pick a standard floor plan and make only limited changes. Spend your money on finishes and decorative touches, not on some off-the-wall razzle-dazzle concept.

The exterior of your house should have clean, good looks. Don't spend a ton of cash on fancy fascia or used-brick planters. The basic shape, proportion and scale of your home should harmonize with other houses on the street and radiate a pleasant and comfortable feel, before you even put on the exterior and interior finishes. It's best not to be the most expensive house on the block. The other expensive homes will boost the value of your property. If yours is the most expensive house on the street, the others will tend to drag down its value.

Work for overall continuity in your property's exterior appearance. A quality property doesn't have 100 percent of the design goodies on the front and nothing on the other sides. Spread some of the design elements around your property. If you use brick or wood siding on the front, put some on the sides and rear, too. The same goes for stucco, paint and planters. Be consistent. Avoid curbside architecture.

Spend your time and money simplifying the construction design and avoiding waste. Build the simplest way possible. Keep dimensions to multiples of two feet to reduce waste of lumber, wallboard and cutting labor.

Layout

Keep the foundation plan simple. Adding two extra exterior corners to a four-cornered house will increase your costs by about 3 percent, even if nothing else changes and the floor area remains the same. A house with ten exterior corners will cost about 8 percent more than an otherwise identical house with four exterior corners. Align interior walls vertically to eliminate unnecessary framing. Align bathrooms vertically or place them back to back. Eliminate unneeded beams and custom-length roof joists and studs.

Provide adequate space. Make the rooms big enough to live in and furnish comfortably. Give it enough bathrooms. Reduce or eliminate long hallways. Build an attractive and efficient kitchen with a granite countertop and an island. Include an in-counter stove top — ceramic glass, radiant heat cook top — wall-mounted convection-heating double oven, energy and water conserving dishwasher, double sink with garbage disposal and a microwave oven. Forget the trash compactor — it won't sell the kitchen. But remember, it's kitchens and bathrooms that sell houses. If you're going to splurge anywhere, these are the two places to do it. Consider a country kitchen that incorporates a breakfast nook and provide a dining room big enough to seat eight, if that's your market.

Increasing the floor area of rooms beyond the minimum makes good sense from two perspectives. First, it makes the house easier to sell. Second, homes with larger rooms are more likely to be over-appraised than under-appraised. Here's why. *Small rooms cost more to build per square foot of floor space than larger rooms. Small houses cost more to build per square foot of floor than larger houses* — just as smaller automobiles are proportionally more expensive to build than large ones.

Most appraisers are not very good judges of construction costs. They don't recognize the higher proportional cost of small rooms and may not realize the economy of larger rooms. And an appraisal is a measure of what the house will sell for, regardless of what it costs to build. Get a high appraisal and you increase the loan value. That makes it easier to get your selling price.

"Small rooms cost more to build per square foot of floor space than larger rooms."

Children's bedrooms should be about 12' x 12'. The master bedroom can be 14' x 16', if there's a separate dressing area, walk-in closet and bathroom. In the master bathroom, provide a tub (consider a Jacuzzi), a double sink in the counter and a stand-alone shower rather than a shower/tub combination, if you can afford it. Forget the gold fixtures and the bidet. If you're going to use brass colored hardware, be sure it's the new PVD-coated type that doesn't corrode after a couple of years. Avoid fancy wallpaper and harsh paint colors. Stick with muted tones that blend well.

Use masonry tile in the entry and consider hardwood for the dining room floor. Use quality carpet with neutral colors elsewhere for a spacious, homey atmosphere.

Make your interiors tasteful and middle-of-the-road. Stay away from extreme design solutions. Don't let your wife be the interior decorator. I'll admit that wives are generally better at this than their husbands, but a trained professional can do an even better job, is more likely to stay within a budget, and can take instructions gracefully.

Extra Touches

Here are a few items that I always include in my spec homes. First, consider lighting. Don't put ceiling lights in any room other than the dining room. Use switched wall sockets instead. And use wall lights sparingly. In a large living room, concealed lighting is worth considering. Spend your lighting money to create a dazzling entryway and an elegant dining room. Front porch lighting should cost at least $300. The dining room chandelier should run from $800 to $1,200. Does that sound expensve? Try it. This is the voice of experience speaking. Spend the money and see what happens. If you think an 18-inch-diameter fixture seems about right, buy a 36-inch instead. Both the appraiser and potential buyers will remember an oversized fixture.

Spend a few extra dollars on a real masonry fireplace. Don't build corner fireplaces. You can't sit more than two people in front of them. Design vaulted open-beam ceilings in the living and dining rooms, but make them simple to build. Don't use complex framing or hip-roofed ceilings.

Attention to basics sells homes. But the basics have to be beefed up and well-presented. When a buyer or appraiser walks up to the front door of your new house, they should be able to feel quality. But a feeling of quality

Good spec home design (Courtesy of Allplans.com)
Figure 14-3

doesn't have to cost a bundle of money. Keep your costs down by keeping your construction as simple as possible.

Confuse the appraiser with the utter simplicity of your project, the scale of your ceilings, lighting and rooms, but mostly with the quality of your finishing touches. *Remember, the selling price and loan amount available are based on the impression of value, not on the cost of construction.*

Off-the Shelf Designs

Finally, you don't necessarily have to have a brand new design for your spec house, unless there's some specific feature of the lot that requires it. There are hundreds of standard designs of houses available that can be found and purchased on the internet. One such website is www.Allplans.com which offers design drawings for just about every conceivable style of house to suit any area of the country. Figure 14-3 shows an example of one such design.

Look for the features I've just described in any of the pre-designed houses that you're considering. Whether you're having your house designed from scratch or selecting it from a long list of available designs, the same criteria apply. If you can't find a design that fits all your needs for a modest fee, you can get an architect to modify the one that comes closest to what you're looking for.

In Summary

There's always room for one more successful builder in the construction industry. It might just as well be you. But I know of no way to be successful in the construction industry without getting your house in order first. As the saying goes, "If you're in a hole, stop digging." Cut back your expenses to the bone, pay off the creditors that you can, and convince the rest that they should wait for their money until you've had time to get back in the black. If they're not cooperative, there are a number of ploys you can use, with bankruptcy as your last resort. If bankruptcy is in your plans, make sure you get the best possible legal advice.

Consider what sacrifices you and your family are willing to make. Building is demanding work; make no mistake about it. It puts pressure on you, your wife and your children. And don't lose your perspective. Professional recognition and a big salary are nice, but they don't replace the personal satisfaction that a happy family give you.

Spend time thinking about your purpose and your goals. There's no point tackling big projects with only half-baked ideas. That's like setting out on a road trip without a map.

Be realistic about where you're going and what you plan to accomplish. Determine exactly what kind of work you want to do and the kind of professional company you want to develop. Find your own niche in the construction business. Work at specialties that enable you to make a good profit margin. Avoid high-risk jobs that could be financially terminal.

Pay attention to swings in inflation. Every builder's future is tied to the ups and downs of the economy. Inflation will give you a big financial boost if you own land and property that appreciates faster than the dollar declines. Use the multiplying effect of inflation to line your pockets with profits.

Make sure that you have as good a bookkeeping system as you can afford, both in personnel and software. Knowing where you stand financially at all times, and what the trends in your business are, is invaluable. It will help you make good decisions and avoid crises. If you're not yet computer savvy, once you've climbed out of that hole, it's time to become so. Personal computers have revolutionized bookkeeping, estimating, scheduling and contract writing. If you're not using these tools, you're really putting yourself at a competitive disadvantage.

Building spec homes, especially if you can retain an equity position in some of them, is an excellent way to increase your net worth rapidly. However, there are recessionary times when it's simply better not to operate as a speculative builder. When times get tough, you should try to get contracts with government agencies or large corporations. Let them pay the bills and take the risks.

Keep some liquid reserves at all times. Cash is king. Money talks, both in good times and bad. Cash reserves will keep you in the game when your competitors are falling by the wayside. Have $10,000 to $20,000 in cash reserves available at all times, above and beyond your monthly expenses and investment commitments.

Make yourself available to your clients and creditors. Keep them informed and you'll keep them on your side. Use a company leaflet/brochure to keep potential clients informed of your company's capabilities. Have an expert set up a company website for you and keep it updated. Present yourself as the earnest, forthright and competent construction professional that you are.

"Cash reserves will keep you in the game when your competitors are falling by the wayside."

There's no way to avoid all the flakes and suede shoe operators who abound in the construction development business. Your best protection is to get a recent financial statement and credit and personal references. Make sure to find out early on where the project money is coming from. If you can't find the source of the financing, chances are the project will never get built. If things don't add up initially, insist on more information until they do, or drop it like a hot potato.

Local, state and federal government agencies are your partners on every project you undertake. Find a way to work in harmony with them. Don't get yourself into an adversarial position with any local official. Promote a team effort. Keep the lines of communication open. Find out early on what's required. Don't just wait for problems to come up. Take a leadership position. Start by getting on a first name basis with key people in City Hall, especially in the planning and building departments.

Every builder has to learn how to compete in the construction business. Find out what type of work is available at what prices. You have to bid smartly to get a significant amount of work. If you're lousy at pricing, take the time and trouble to become an expert estimator. Remember, the serious money in construction is in building for yourself. *A developer makes three profits — on the construction, on the land and as an entrepreneur-speculator.* In a strong economy, there's no better money-maker around. To make the big bucks, you need to have a piece of the action, either through direct purchase, design-and-build or trading. To be successful, buy property, develop it, keep it and let inflation do the rest.

No one in any business has a better shot at building wealth than a knowledgeable, resourceful and aggressive construction contractor. The construction business is the best field to be in to take advantage of the opportunities. Good luck!

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APPENDICES:

1. Blank Forms

2. Converting an Income versus Expenses Bar Chart into a Graph

3. Minutes-to-Hundredths-of-an-Hour Conversion Chart

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Appendix 1: Blank Forms

The following 14 pages contain some useful blank charts that you can simply copy and use to generate your own records. You can also use your computer to generate similar charts in a spreadsheet program such as Microsoft's Excel, and then you can easily add the data you wish and modify it as necessary, without having to start all over again. In addition, a computer spreadsheet will do the math for you so that computational errors are virtually eliminated.

Figure A1-1	Financial Statement
Figure A1-2	Income Inventory List
Figure A1-3	Indebtedness Priority List
Figure A1-4	Income Statement
Figure A1-5	Balance Sheet
Figure A1-6	Daily Time Slip
Figure A1-7	Take-off Work Sheet

Figure A1-1 Financial Statement

This is a blank financial statement. Fill in the columns labeled Assets and Liabilities as accurately and honestly as you can. At this stage, what you need most is the unvarnished truth — a clear picture of where you stand. The more you know about the hole you're in, the easier it will be to climb out. If you're computer savvy and have Microsoft Office, use an Excel spreadsheet to craft a financial statement. A computer spreadsheet is easier to modify and does the math for you.

If you don't have a computer, no problem. Pencil and paper work almost as well. Anyhow, this is no time to start learning a computer program. Save that for when the business has stabilized.

Whether in Excel or with pencil and paper, on Figure A1-1, list everything you own under Assets, paid for or not. Under the Liabilities column list everything you owe, even if the asset is pledged as security for some loan. When done, total the columns and compare the numbers. The difference between the two is your Net Worth. See Figure 1-1 on page 10 for an example of this form filled in.

FINANCIAL STATEMENT

NAME: ______________________ DATE: ____________

No.	ASSETS	VALUE	No.	LIABILITIES	AMOUNT
1			1		
2			2		
3			3		
4			4		
5			5		
6			6		
7			7		
8			8		
9			9		
10			10		
11			11		
12			12		
13			13		
14			14		
15			15		
16			16		
17			17		
18			18		
19			19		
20			20		
21			21		
22			22		
23			23		
24			24		
25			25		
	TOTAL ASSETS $__________			TOTAL LIABILITIES $__________	

NET WORTH = $__________ MINUS $__________ = $__________

Figure A1-2 Income Inventory List

Start by listing your immediate sources of income and assets. Make a copy of the blank spreadsheet, called Income Inventory, and list every possible source of income and assets you can think of. Again, if you're computer savvy and familiar with the Microsoft Office programs, you can make up your own Income Inventory spreadsheet. If not, simply make a copy of Figure A1-2. Include in this Income Inventory every dollar of profits, overhead, supervision and subcontract work you can possibly pull out of the monthly progress payments for each job you have under contract. Figure 1-4 on page 19 shows what this completed Income Inventory list should look like.

INCOME INVENTORY

NAME: ____________________ DATE: __________

No.	ITEM	SOURCE / ACTION	AMOUNT
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
16			
17			
18			
19			
20			
21			
22			
23			
24			
25			

TOTAL $__________

Figure A1-3 Indebtedness Priority List

Now you need to prepare a list of your monthly living expenses and your outstanding bills. Make a copy of Figure A1-3, called Indebtedness Priorities, or simply make another Excel spreadsheet and divide it into three vertical columns, headed LIVING EXPENSES, PAYABLE EXPENSES and UNPAYABLE EXPENSES.

Column 1 is for essentials only. They'll be paid 100 percent each month. After all, you've got to live. That's the highest priority, though you'll have to cut back on some of your discretionary spending, such as clothing and entertainment. Column 2 is for creditors who you plan to pay small monthly payments (you'll need to get their agreement, of course), and Column 3 is your wish list. . . no payments at all for the present; just a big wish. But be up front with these creditors. Tell them their name is in the hat. If they object, you can always offer to take their name out of the hat. See Figure 1-6 on page 21 for an example of this form filled in.

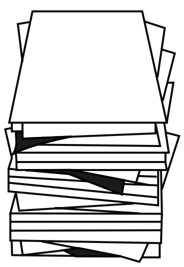
INDEBTEDNESS PRIORITIES

NAME: ______________________________ DATE: ______________

NO.	LIVING EXPENSES		PAYABLE EXPENSES		UNPAYABLE EXPENSES	
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11						
12						
13						
14						
15						
16						
17						
18						
19						
20						
21						
22						
23						
24						
25						

Totals $________ $________ $________

Figure A1-4 Income Statement



So what should an Income Statement look like? You'll find various formats for an Income Statement, again depending upon which accounting text you consult, but they'll all have pretty much the same headings, and it'll only be in the sub-headings that the differences will generally occur. I've shown a typical Income Statement format in Figure A1-4, which you can simply copy, or you'll find an Excel file version on the CD accompanying *Contractor's Guide to QuickBooks Pro* published by Craftsman Book Company. Figure 2-9 on page 45 shows an example of a completed Income Statement for our fictitious company, Twice Right Construction.

INCOME STATEMENT

NAME: ______________________ DATE: ____________

GROSS SALES		$ ______
CONSTRUCTION COSTS		
LABOR		
MATERIAL		
EQUIPMENT		
SUBCONTRACT		
TOTAL COSTS	$ ______	
GROSS PROFIT FROM CONSTRUCTION		$ ______
OTHER INCOME: INTEREST FROM INVESTMENTS		$ ______
ADJUSTED GROSS INCOME		$ ______
OVERHEAD		
MANAGEMENT SALARY		
ESTIMATOR/PROJECT MANAGER SALARIES		
CLERICAL SALARIES		
OFFICE EXPENSES		
LEGAL, AUDIT, MISCELLANEOUS		
EQUIPMENT NOT COSTED TO JOBS AS EXPECTED		
TOTAL OVERHEAD COSTS		$ ______
PROFIT (LOSS) BEFORE TAXES		$ ______

NOTES:

1. ALL LABOR COSTS INCLUDE FRINGE BENEFITS AND TAXES.
2. EQUIPMENT OVERHEAD COST REPRESENTS TOTAL COST LESS $'S CHARGED TO JOBS (UNUSED TIME).

Figure A1-5 Balance Sheet

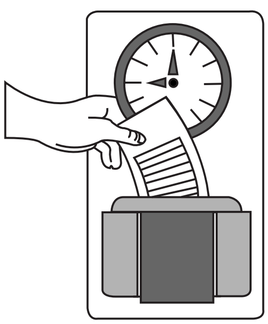
So what should a Balance Sheet look like? Figure 6-2 on page 118 shows a typical format for a balance sheet. Depending upon which accounting text you consult, you'll find a number of minor variations in what's included under each heading. The one constant is that the Total Current Assets line must equal the Total Liabilities and Net Worth/Owner's Equity line. This balance sheet is based upon the format found in *Contractor's Guide to QuickBooks Pro*. To make up your own balance sheet you can copy this version from Figure A1-5 or copy the Excel file found on the CD which accompanies *Contractor's Guide to QuickBooks Pro*.

BALANCE SHEET

NAME: ____________________ DATE: ____________

CURRENT ASSETS		
CASH		
ACCOUNTS RECEIVABLE		
INVENTORY		
PREPAID EXPENSES	$	
TOTAL CURRENT ASSETS		$
FIXED ASSETS		
PROPERTY		
EQUIPMENT	$	
TOTAL FIXED ASSETS		$
TOTAL ASSETS		$
LIABILITIES		
CURRENT — ACCOUNTS PAYABLE		
SALARIES PAYABLE		
CREDIT CARDS		
TAXES		
LONG-TERM NOTES PAYABLE	$	
TOTAL LIABILITIES		$
NET WORTH/OWNER'S EQUITY		
OWNER'S INVESTMENT/COMMON STOCK		
RETAINED EARNINGS		
TOTAL NET WORTH/OWNER'S EQUITY		$
TOTAL LIABILITIES AND NET WORTH/OWNER'S EQUITY		$

Figure A1-6 Daily Time Slip



Most companies use simple time cards that can be bought at a stationery store. Alternatively, you can make copies of the Daily Time Slip from Figure A1-6, or from the Forms file on the CD supplied with *Contractor's Guide to QuickBooks Pro*, shown in Figure 6-11 on page 130.

The time card records the time an employee worked each day. You can also use it to record the job number and the type of work done during that time. You should have a separate time slip for each employee and a specific number for each aspect of the job, from your Items List. The employee should write in, opposite the time worked, a short description of the work done. This can be used later to figure job costs and to compare estimated costs versus actual costs. These data can then be used to adjust future estimates.

Generally, you use one card per employee per week. The employee should write in his start and end times using military time — 100-minute hours and 24-hour days, (i.e. 13.25 rather than 1:15 pm). You may feel it's adequate to record job time to a minimum of a quarter of an hour. That makes it easy to convert to 100-minute hours since a quarter of an hour is 15 minutes, and a quarter of a 100-minute hour is 0.25. If you want to be more accurate than 15 minutes you'll need to give each employee a copy of the Minutes-to-Hundredths-of-an-Hour Conversion Table shown in Appendix 3.

DAILY TIME SLIP

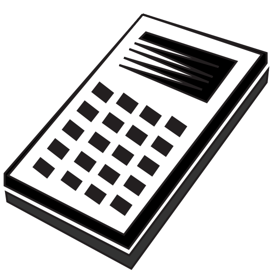
WORK DONE BY ______________________________ PAYROLL NO. ______________

JOB NAME ______________________________ DATE ______________

WORK DESCRIPTION	COMMENT	START TIME	END TIME	TOTAL TIME	CODE NO.	ADJUST	ADJUST TOTAL
			TOTALS				

Figure A1-7 Take-off Work Sheet

Your take-off should look something like Figure 13-1 on page 264, which is a single page listing of the electrical take-offs for one drawing (Figure 13-2) on page 265, a small office complex and workshop. You'll note that this sheet of the take-off is the first of seven sheets that covers the lighting fixtures and lamps on a number of the electrical drawings labeled E3, E4 and E10. This example is taken from *Estimating Electrical Construction*, by Ed Tyler, published by Craftsman Book Company.



You can do the take-off manually, of course, just by counting the numbers of each item and recording the quantity in a list. You'll find a blank table for this purpose that you can copy, Figure A1-7. However, this particular take-off was done using an electronic counting tool coupled directly to the estimator's computer. When each count was completed, a single click of the tool dumped the count number into the selected cell in an Excel spreadsheet. You can generate your own spreadsheet if you're familiar with Excel. As the cells in any one item row are filled in, the spreadsheet automatically totals the number in the right-hand column. This greatly speeds the count of each item and increases the accuracy of the take-off.

TAKE-OFF WORKSHEET

ESTIMATE NO. ________ ESTIMATOR ______________________ JOB NO. ________

JOB DESCRIPTION ____ DATE _______________

BID DUE DATE _______________ CHECKER ___________________ SHEET NO. ______ OF ___

CATEGORY

	DRAWING NO.											
ITEM												TOTAL

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Appendix 2: Converting an Income versus Expenses Bar Chart into a Graph

As I indicated in Chapter 6, there's a more useful way of displaying the Income versus Expenses data shown in Figure 6-9. This is achieved by converting the data from a bar chart to a graph, as shown in Figure 6-10. This is not part of the standard *QuickBooks Pro* program. However, it's a relatively easy conversion, though a little tedious the first time around. So, let's take a few moments to go through the exact process, and you'll find it easy to include additional months' data as it becomes available. Just type the new data into the table that we'll eventually create (in Figure A2-10) and Excel will automatically add the data points to the graph.

First, click on **Reports** on the *QuickBooks Pro* toolbar, and a window will drop down, as in Figure A2-1, from which you should select **Company and Financial**, and then **Profit and Loss Standard.**

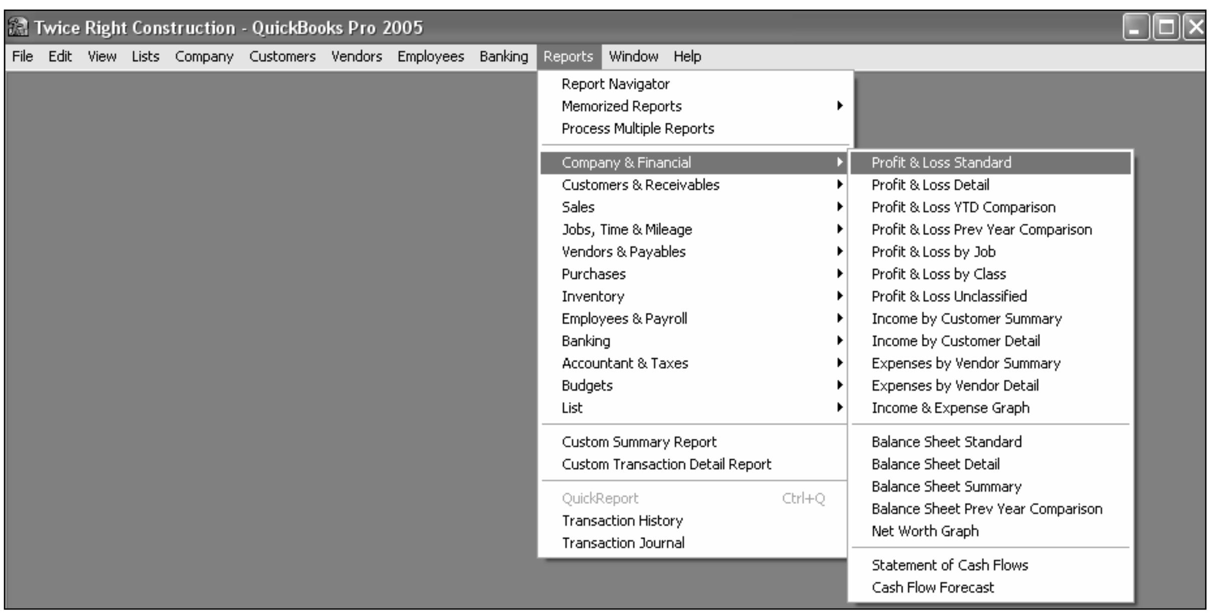


Figure A2-1

This will open a window called **Modify Report: Profit and Loss**, as shown in Figure A2-2. Now in the **Dates** box, you need to select the time period for which you want the report to show the appropriate data. We need the data from September 1st, 2008 to August 31st, 2009, so that's what I've entered.

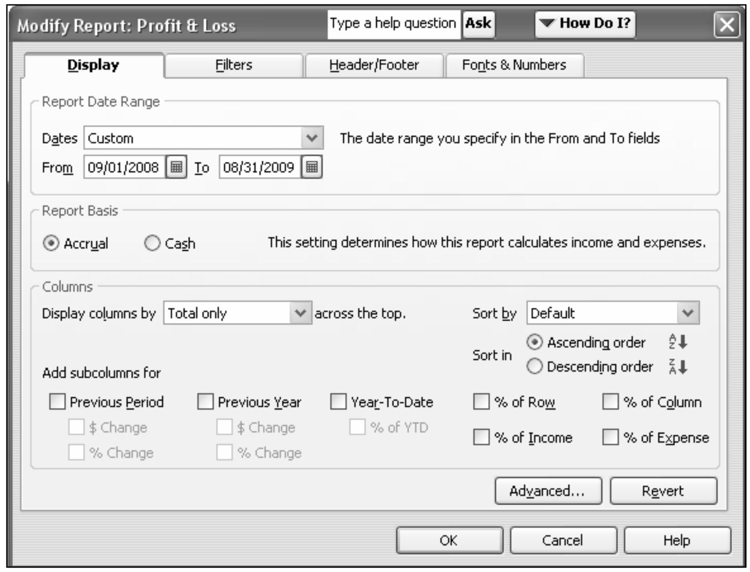


Figure A2-2

Now click on **OK**, and the **Profit and Loss** statement for that time period will be displayed, as in Figure A2-3.

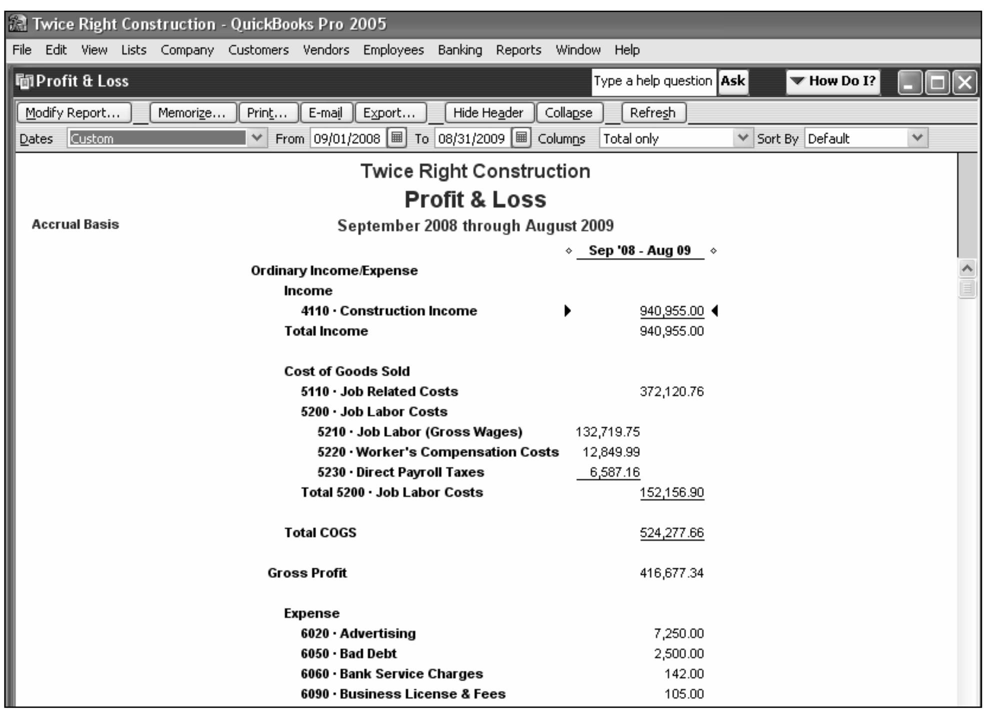


Figure A2-3

This shows only the total figures for the September 2008 to August 2009 period, and we want to see the data on a monthly basis, so click on the down arrow on the box showing **Totals Only**. A window will drop down giving you numerous choices for the intervals in which you can see the data displayed, as shown in Figure A2-4.

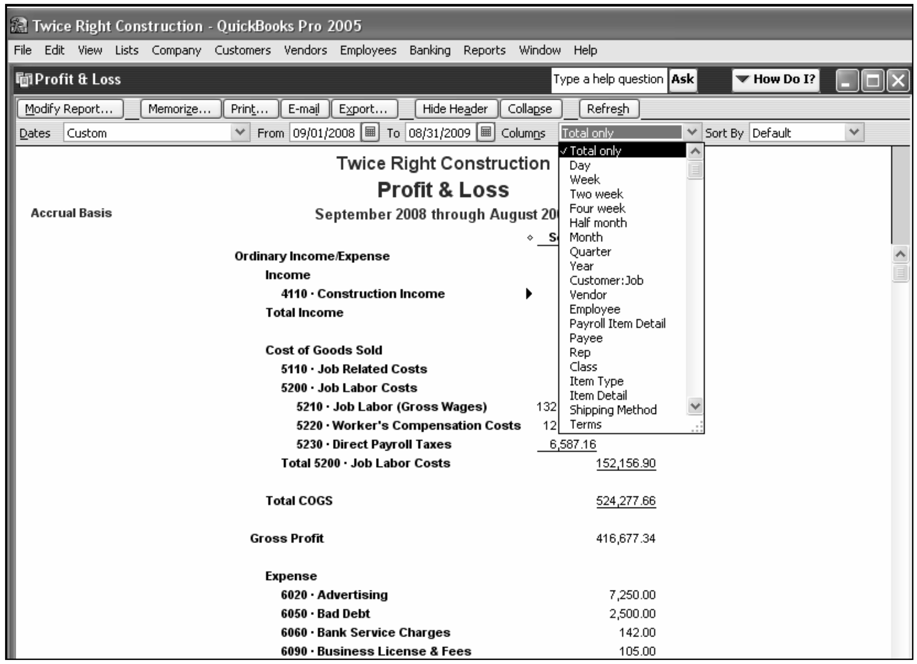


Figure A2-4

A monthly interval is a reasonable time period in which to show the data, so select **Month**. The chart will expand to show the data for each month in the period from September 2008 to August 2009, as in Figure A2-5. Of course, you can select other time intervals if you wish.

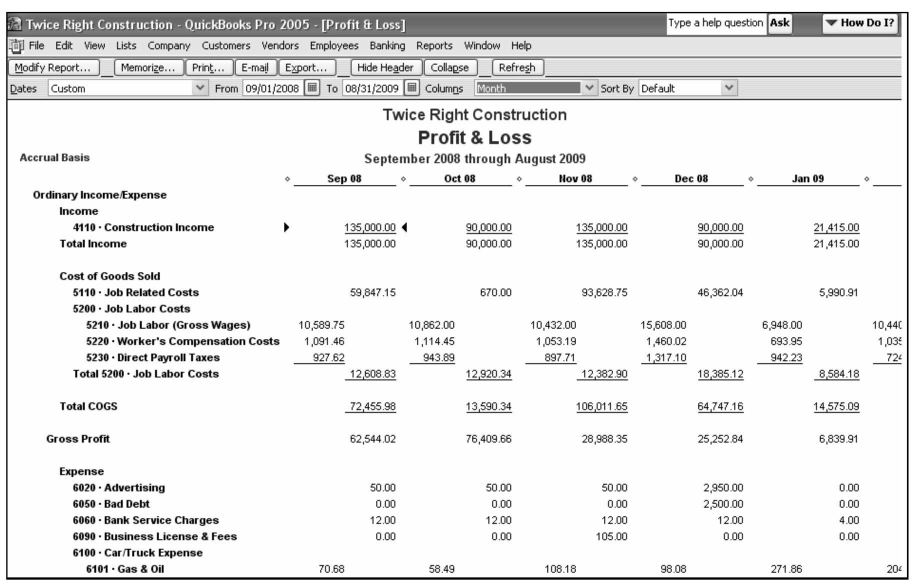


Figure A2-5

Now we need to convert the data to an Excel spreadsheet format, so click on **Export** in the middle toolbar. This will open an **Export Report** window, Figure A2-6, where you want to click on the button under **Export QuickBooks report to: A new Excel workbook.** Then click on **Export**.

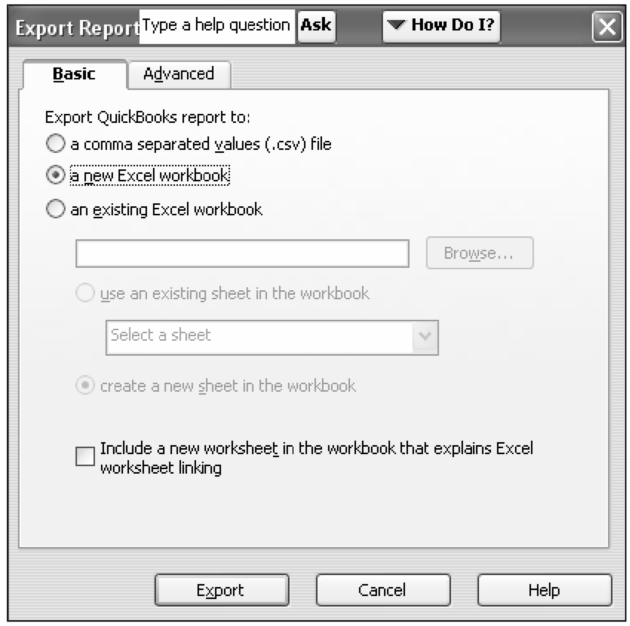
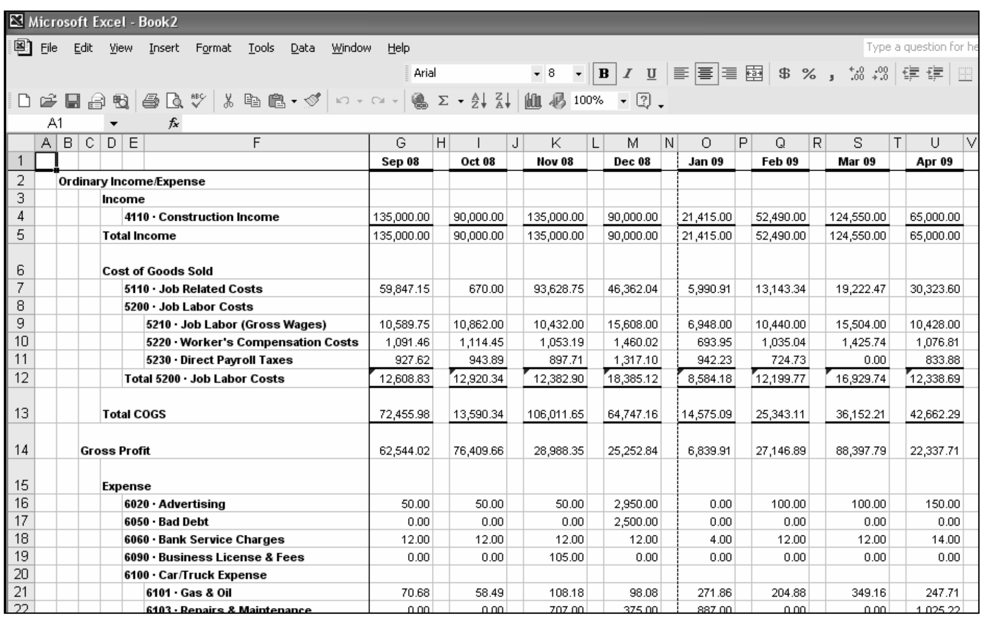


Figure A2-6

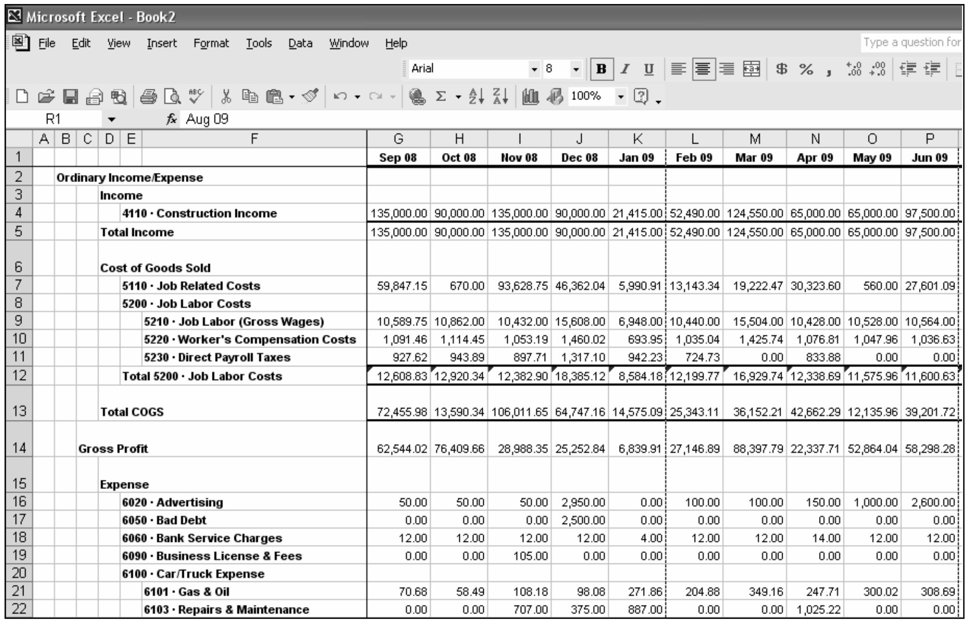
This will open an Excel spreadsheet with the previous data shown in a standard spreadsheet format, Figure A2-7, with which you're now familiar. You can plot a graph from this data, as in Figure 6-10 in Chapter 6. But before you can do that, you must first modify the spreadsheet so that it will plot the graph cleanly.



	F	G	I	K	M	O	Q	S	U
1		Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09
2	Ordinary Income/Expense								
3	Income								
4	4110 · Construction Income	135,000.00	90,000.00	135,000.00	90,000.00	21,415.00	52,490.00	124,550.00	65,000.00
5	Total Income	135,000.00	90,000.00	135,000.00	90,000.00	21,415.00	52,490.00	124,550.00	65,000.00
6	Cost of Goods Sold								
7	5110 · Job Related Costs	59,847.15	670.00	93,628.75	46,362.04	5,990.91	13,143.34	19,222.47	30,323.60
8	5200 · Job Labor Costs								
9	5210 · Job Labor (Gross Wages)	10,589.75	10,862.00	10,432.00	15,608.00	6,948.00	10,440.00	15,504.00	10,428.00
10	5220 · Worker's Compensation Costs	1,091.46	1,114.45	1,053.19	1,460.02	693.95	1,035.04	1,425.74	1,076.81
11	5230 · Direct Payroll Taxes	927.62	943.89	897.71	1,317.10	942.23	724.73	0.00	833.88
12	Total 5200 · Job Labor Costs	12,608.83	12,920.34	12,382.90	18,385.12	8,584.18	12,199.77	16,929.74	12,338.69
13	Total COGS	72,455.98	13,590.34	106,011.65	64,747.16	14,575.09	25,343.11	36,152.21	42,662.29
14	Gross Profit	62,544.02	76,409.66	28,988.35	25,252.84	6,839.91	27,146.89	88,397.79	22,337.71
15	Expense								
16	6020 · Advertising	50.00	50.00	50.00	2,950.00	0.00	100.00	100.00	150.00
17	6050 · Bad Debt	0.00	0.00	0.00	2,500.00	0.00	0.00	0.00	0.00
18	6060 · Bank Service Charges	12.00	12.00	12.00	12.00	4.00	12.00	12.00	14.00
19	6090 · Business License & Fees	0.00	0.00	105.00	0.00	0.00	0.00	0.00	0.00
20	6100 · Car/Truck Expense								
21	6101 · Gas & Oil	70.68	58.49	108.18	98.08	271.86	204.88	349.16	247.71
22	6103 · Repairs & Maintenance	0.00	0.00	707.00	375.00	887.00	0.00	0.00	1,025.22

Figure A2-7

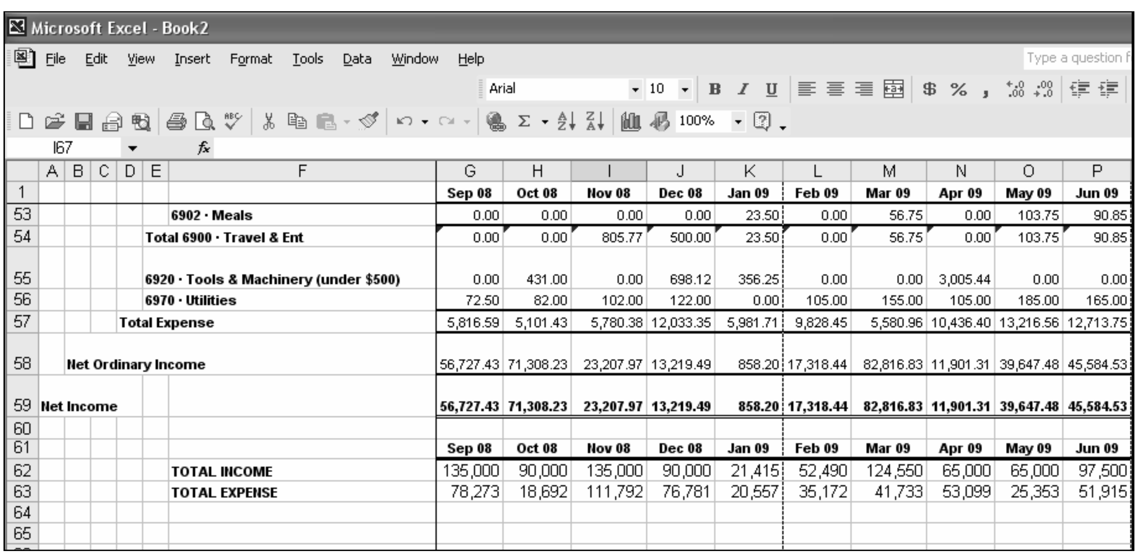
You'll notice that the program has put a spacer column between each month's data. This will confuse the Excel Chart Wizard, so you need to delete the columns H, J, L N, P, R, T, V, X, Z, AB and AD. You do this by clicking on each letter in turn at the top of the chart to highlight each column, then click on **Delete**. After you've deleted the 12 spacer columns, you'll have a spreadsheet that looks like Figure A2-8.



	F	G	H	I	J	K	L	M	N	O	P
1		Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09
2	Ordinary Income/Expense										
3	Income										
4	4110 · Construction Income	135,000.00	90,000.00	135,000.00	90,000.00	21,415.00	52,490.00	124,550.00	65,000.00	65,000.00	97,500.00
5	Total Income	135,000.00	90,000.00	135,000.00	90,000.00	21,415.00	52,490.00	124,550.00	65,000.00	65,000.00	97,500.00
6	Cost of Goods Sold										
7	5110 · Job Related Costs	59,847.15	670.00	93,628.75	46,362.04	5,990.91	13,143.34	19,222.47	30,323.60	560.00	27,601.09
8	5200 · Job Labor Costs										
9	5210 · Job Labor (Gross Wages)	10,589.75	10,862.00	10,432.00	15,608.00	6,948.00	10,440.00	15,504.00	10,428.00	10,528.00	10,564.00
10	5220 · Worker's Compensation Costs	1,091.46	1,114.45	1,053.19	1,460.02	693.95	1,035.04	1,425.74	1,076.81	1,047.96	1,036.63
11	5230 · Direct Payroll Taxes	927.62	943.89	897.71	1,317.10	942.23	724.73	0.00	833.88	0.00	0.00
12	Total 5200 · Job Labor Costs	12,608.83	12,920.34	12,382.90	18,385.12	8,584.18	12,199.77	16,929.74	12,338.69	11,575.96	11,600.63
13	Total COGS	72,455.98	13,590.34	106,011.65	64,747.16	14,575.09	25,343.11	36,152.21	42,662.29	12,135.96	39,201.72
14	Gross Profit	62,544.02	76,409.66	28,988.35	25,252.84	6,839.91	27,146.89	88,397.79	22,337.71	52,864.04	58,298.28
15	Expense										
16	6020 · Advertising	50.00	50.00	50.00	2,950.00	0.00	100.00	100.00	150.00	1,000.00	2,600.00
17	6050 · Bad Debt	0.00	0.00	0.00	2,500.00	0.00	0.00	0.00	0.00	0.00	0.00
18	6060 · Bank Service Charges	12.00	12.00	12.00	12.00	4.00	12.00	12.00	14.00	12.00	12.00
19	6090 · Business License & Fees	0.00	0.00	105.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
20	6100 · Car/Truck Expense										
21	6101 · Gas & Oil	70.68	58.49	108.18	98.08	271.86	204.88	349.16	247.71	300.02	308.69
22	6103 · Repairs & Maintenance	0.00	0.00	707.00	375.00	887.00	0.00	0.00	1,025.22	0.00	0.00

Figure A2-8

Now you need to select the data from which you want to produce your Income versus Expense graph. Scroll down to the bottom of the spreadsheet and type in TOTAL INCOME and TOTAL EXPENSE on two consecutive rows in the F column, as shown in rows 62 and 63, in Figure A2-9. Leave row 61 empty for just a moment.



	F	G	H	I	J	K	L	M	N	O	P
1		Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09
53	6902 · Meals	0.00	0.00	0.00	0.00	23.50	0.00	56.75	0.00	103.75	90.85
54	Total 6900 · Travel & Ent	0.00	0.00	805.77	500.00	23.50	0.00	56.75	0.00	103.75	90.85
55	6920 · Tools & Machinery (under $500)	0.00	431.00	0.00	698.12	356.25	0.00	0.00	3,005.44	0.00	0.00
56	6970 · Utilities	72.50	82.00	102.00	122.00	0.00	105.00	155.00	105.00	185.00	165.00
57	Total Expense	5,816.59	5,101.43	5,780.38	12,033.35	5,981.71	9,828.45	5,580.96	10,436.40	13,216.56	12,713.75
58	Net Ordinary Income	56,727.43	71,308.23	23,207.97	13,219.49	858.20	17,318.44	82,816.83	11,901.31	39,647.48	45,584.53
59	Net Income	56,727.43	71,308.23	23,207.97	13,219.49	858.20	17,318.44	82,816.83	11,901.31	39,647.48	45,584.53
60											
61		Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09
62	TOTAL INCOME	135,000	90,000	135,000	90,000	21,415	52,490	124,550	65,000	65,000	97,500
63	TOTAL EXPENSE	78,273	18,692	111,792	76,781	20,557	35,172	41,733	53,099	25,353	51,915
64											
65											

Figure A2-9

Now, type into cell G61 the following: =G1 and press [Enter ↵]. This will add the **Sept 08** that is in G1 to cell G61. Next, highlight the cells G61 through R61 and hold down [Ctrl] and press [R] simultaneously. This will fill in the remaining cells H61 through R61 with the months from H1 through R1.

Then, type into cell G62 the following: =G5 and press [Enter ↵]. This will add the number that is in G5 to cell G62. Next, highlight the cells G62 through R62 and hold down [Ctrl] and press [R] simultaneously. This will fill in the remaining cells H62 through R62 with the data from H5 through R5.

Finally, type into cell G63 the following: =G13+G57 and press [Enter ↵]. This will add the data from these two cells, (which are Total COGS (Total Cost of Goods Sold) and Total Expenses) and show them as a total Expense figure in cell G63. Next, highlight the cells G63 through R63 and hold down [Ctrl] and press [R] simultaneously. This will fill in the remaining cells H63 through R63 with the appropriate data.

You are now ready to produce a graph, as in Figure 6-10. Highlight the cells F61 through R63 and click on the Chart Wizard icon on the Excel toolbar. The following window, Figure A2-10 will appear.

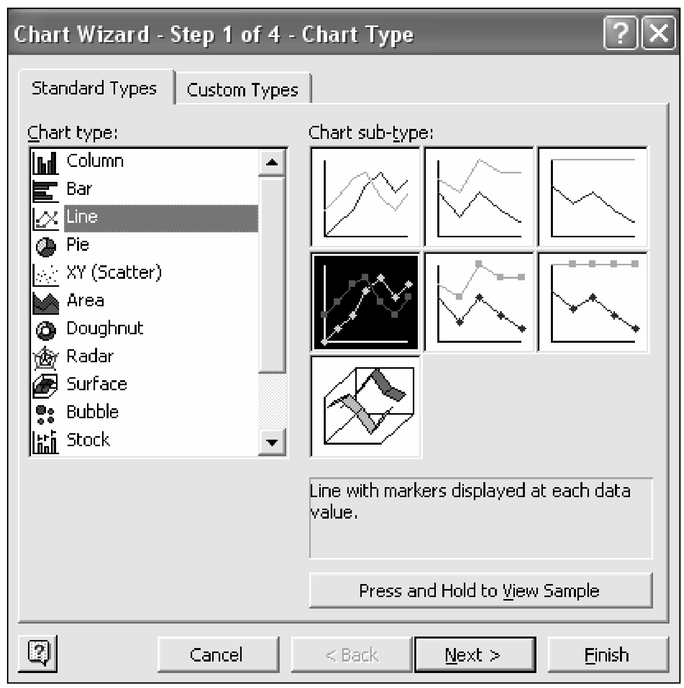


Figure A2-10

Now, click on **Line** and select the fourth **Chart sub-type**, as indicated. Then, click on **Next**, and a preview of the desired graph will appear, as in Figure A2-11. This looks like the type of graph we were expecting, so click on **Next** and Figure A2-12 will appear.

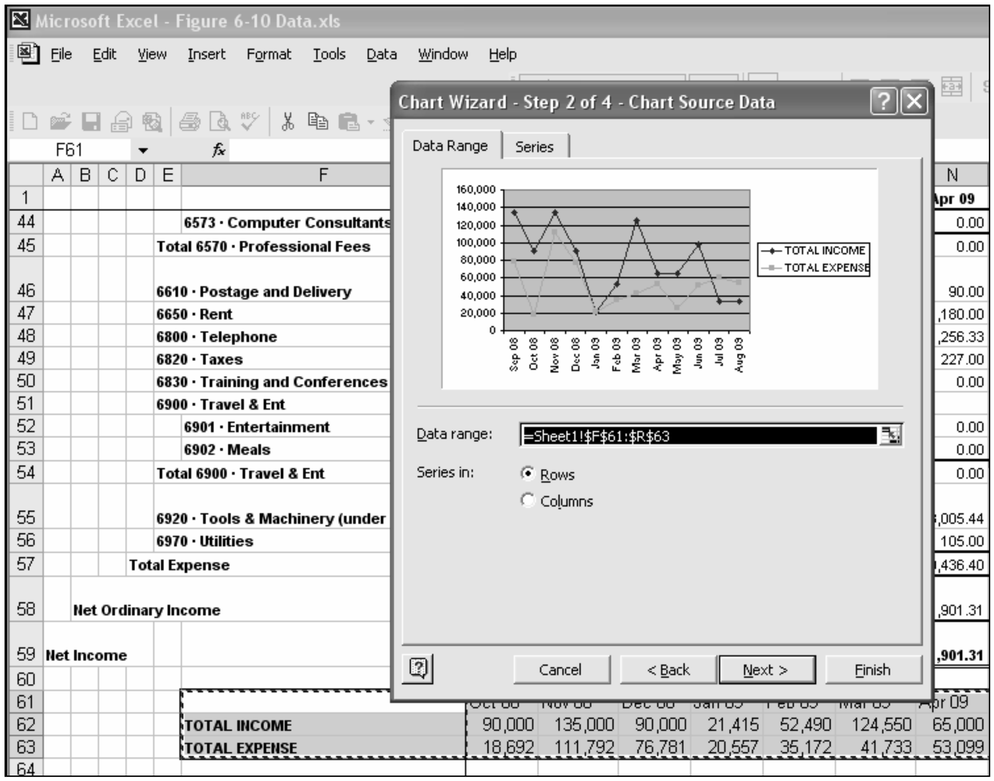


Figure A2-11

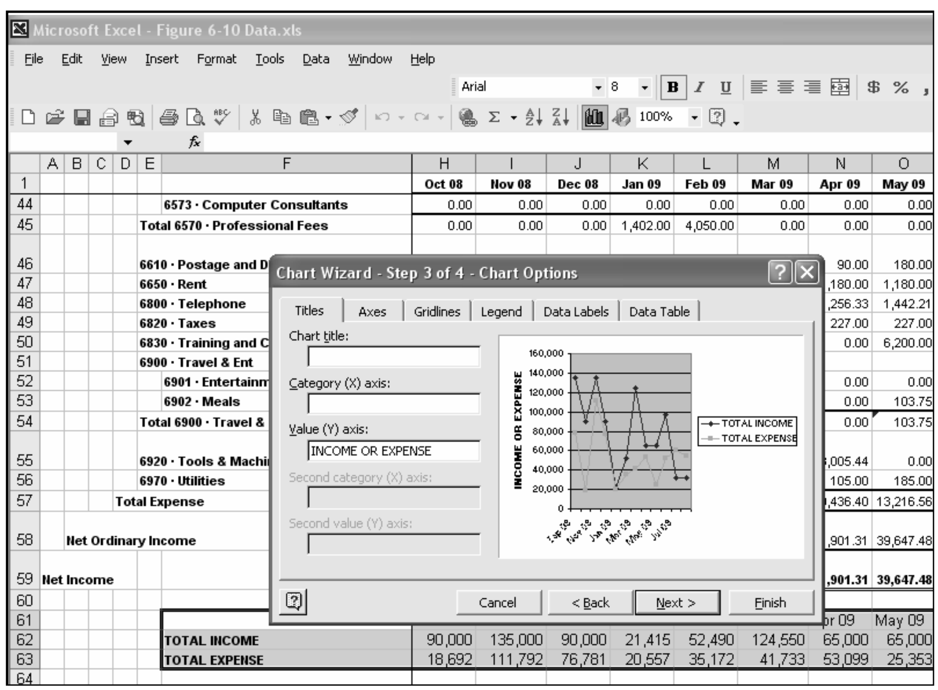


Figure A2-12

Now in the **Value (Y) axis** box, type INCOME OR EXPENSE and click on **Next**. Figure A2-13 will appear.

You can also clean up the presentation of the graph as much as you wish.

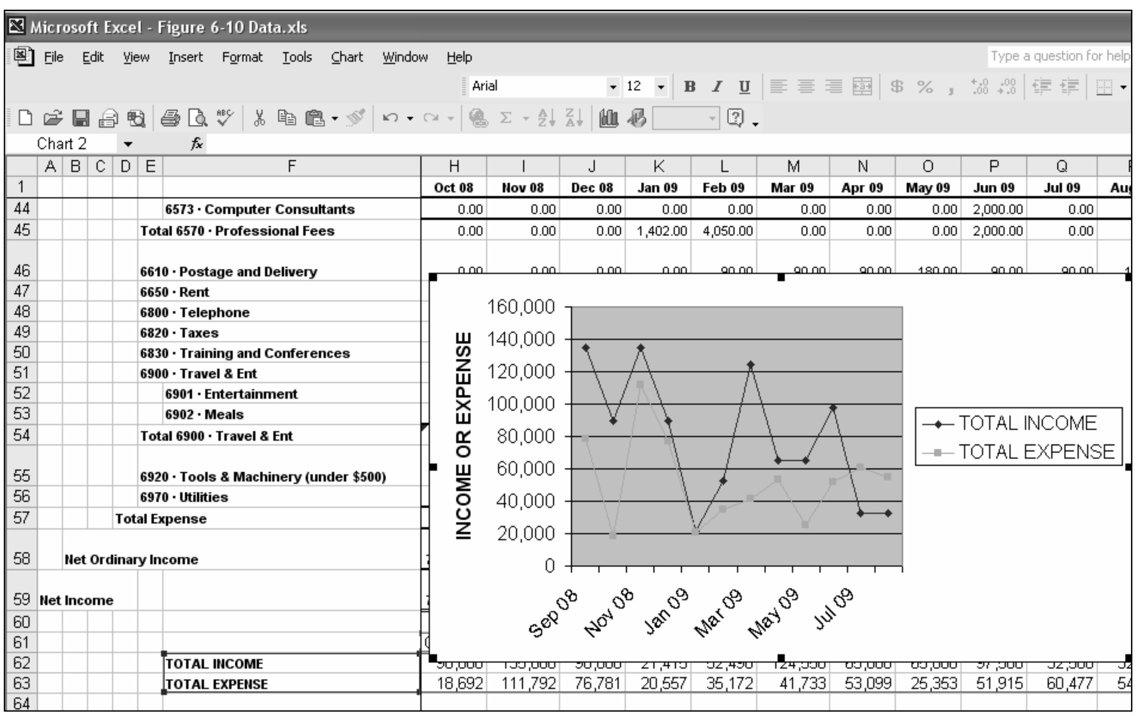
You may want to remove the right hand box with TOTAL INCOME and TOTAL EXPENSE in it, as this is fairly obvious, hopefully. You do this by simply clicking on the box which will then show small dark squares at each corner. Click on **Edit** in the Excel toolbar and then, in the window that drops down, select **Delete**. The box and contents will disappear, leaving more room for the graph itself.

You can expand the graph by clicking and holding on the bottom right hand corner of the graph, and dragging it to the southeast. This will allow space for the intervening months to be shown along the X axis.

You can click on the individual graph lines and windows will appear to allow you to change the color and type of lines used for each graph line. I've changed the Expenses line to be a dashed line to distinguish it from the Income line.

You can click on the Y axis and a window will appear to allow you to add the $ symbol to the numbers shown.

Figure A2-13



The end result should look something like Figure A2-14 and (Figure 6-10).

You can now Copy and Paste this graph into whatever file you want to store it, such as a Word file, as we did in Chapter 6. Click on the white area of the graph and small black boxes will appear at the corners of the outline. You can now Copy (hold down Ctrl and press C simultaneously) and Paste (hold down Ctrl and press V simultaneously) in any document you wish.

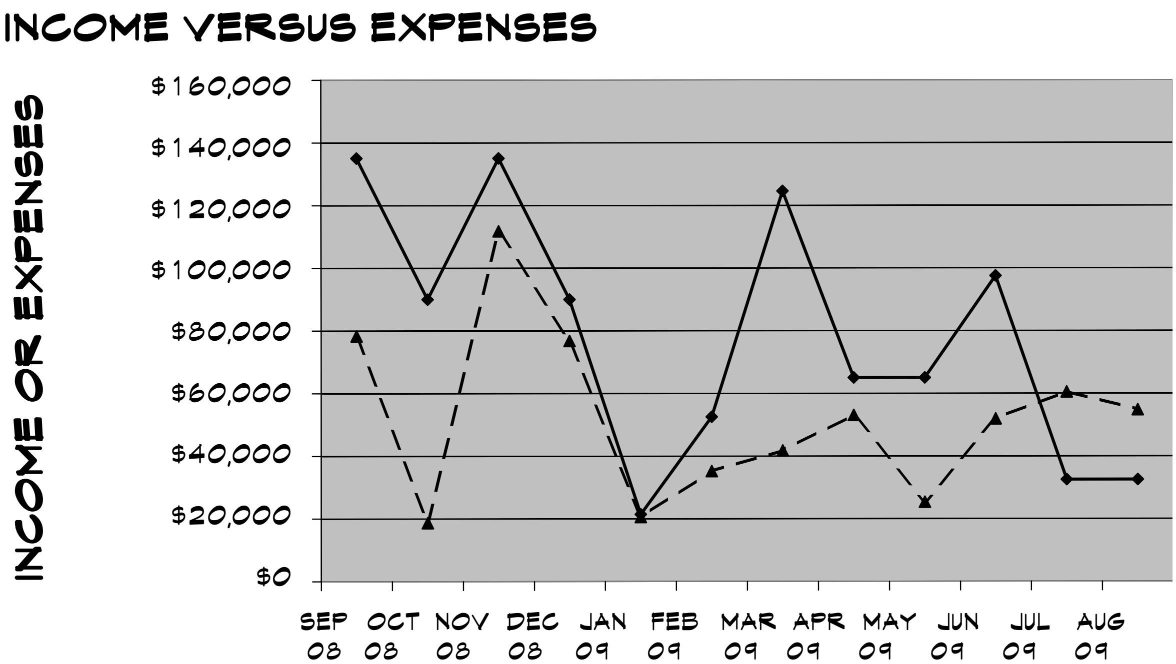


Figure A2-14
Twice Right Construction Income versus Expense graph, Sept 08 to Aug 09

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Appendix 3: Minutes-to-Hundredths-of-an-Hour Conversion Chart

Refer to **Time Cards**, page 130. You'll find an explanation for this chart on page 131.

MINUTES-TO-HUNDREDTHS-OF-AN-HOUR CONVERSION TABLE

Minutes	Hr/100	Minutes	Hr/100	Minutes	Hr/100	Minutes	Hr/100
1	2	16	27	31	52	46	77
2	3	17	28	32	53	47	78
3	5	18	30	33	55	48	80
4	7	19	32	34	57	49	82
5	8	20	33	35	58	50	83
6	10	21	35	36	60	51	85
7	12	22	37	37	62	52	87
8	13	23	38	38	63	53	88
9	15	24	40	39	65	54	90
10	17	25	42	40	67	55	92
11	18	26	43	41	68	56	93
12	20	27	45	42	70	57	95
13	22	28	47	43	72	58	97
14	23	29	48	44	73	59	98
15	25	30	50	45	75	60	100

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R