

Accrual vs. Cash Accounting: Why Bother?

by Leslie Shiner

If you're like most contractors I know, you view accounting as a necessary evil. You know you should understand it better, but it's an uphill struggle to even think about it.

Yet what's one of the first business decisions a new contractor has to make? — whether to use the cash or accrual method of accounting.

Most contractors go with a cash-basis system because it relates well to their checkbook and is easy to understand. The problem is, cash-basis accounting may not reflect the true profitability of your business. The purpose of this article is to explain why it's usually better to use the accrual method.

Accurate Financial Statements

As a contractor, you probably know how much you have spent on every job so you can have a rough idea of the gross profit for each project. But if you look only at individual jobs, you may miss the forest for the trees. Each project may appear to be profitable, but increased overhead, warranty expenses, or one bad loss can reduce or eliminate the cumulative gross profit for all of your jobs.

The only way to accurately measure your profit is to create and review an income statement. The basic format for the statement is this:

$$\begin{aligned} \text{income} - \text{direct expenses} &= \\ \text{gross profit} & \\ \text{gross profit} - \text{overhead} &= \text{net profit} \end{aligned}$$

These numbers come from your accounting system, so the accounting method you use will have an effect on the net profit number you get. It's a question of timing — when income dollars or expense dollars actually

appear on the books. They'll show up sooner if you use the accrual method, and therefore will give you a more accurate picture of the state of your business.

True, Cash Basis Is Simple

If you operate on a cash basis, income doesn't show up until the money is deposited in the bank. Expenses don't show up until you have written the check to pay them. This has the advantage of being simple. You typically can't show a profit unless there is more money in your checking account now than there was when you started.

However, there are some big drawbacks to this method. Financial statements based on cash accounting can be very misleading; plus, it's easy to manipulate the numbers — accidentally or on purpose. For example, if you're short on cash, you won't be able to pay your bills. On a cash basis, you don't have any expenses until you pay your bills. A cash-basis income statement could trick you into thinking you're profitable when what's really going on is you don't have enough money to pay the bills.

This is not as far-fetched as it sounds. I knew a contractor who thought he

Same Job With Different Accounting Methods

Contract price	\$121,000
Estimated cost	(\$100,000)
Estimated overhead	(\$10,000)
Anticipated profit	\$11,000
Invoices sent to client	\$40,000
Checks deposited from client	\$36,000
Bills received from vendors	\$45,000
Amount paid to vendors	\$25,000
Overhead billed and paid	\$4,000

<u>Financial Statement</u>	<u>Cash</u>	<u>Accrual</u>
Income	\$36,000	\$40,000
Direct expenses	(\$25,000)	(\$45,000)
Gross profit	\$11,000	(\$5,000)
Overhead	(\$4,000)	(\$4,000)
Net profit	\$7,000	(\$9,000)

If the builder has invoiced the client for all the work done to date, then this job is about 33% complete. On a cash basis, it looks like the contractor has made \$7,000 so far and will have a profit of \$21,000 (3 x \$7,000) by the time the project is complete. The accrual-based statement is closer to the truth; it suggests that if something doesn't change, the contractor will lose \$27,000 (3 x \$9,000) on the job.

was making a large profit on a job. He was shocked to discover that his bookkeeper had not paid for much of the material, so he owed his suppliers a lot of money. When he added up all the expenses for the job, including the ones he had yet to pay, it turned out that his expected profit was actually a loss (see table, previous page).

You can manipulate profitability by deciding when to print a check. If you don't write the check, you won't show the expense and you may appear to be profitable. If you do create the check, it looks like you're losing money. Which is correct? With cash-basis accounting, it's impossible to know how much profit you made until the end of the job when all the bills are paid and all the payments are in. Contractors are frequently fooled into thinking they're more profitable than they are. They feel so good about the money in the bank that they go out and buy a new truck or a boat — using “profits” that don't really exist.

Accrual Basis Requires Understanding

The preferable method of accounting is accrual based. Under this system, income appears when it's earned and expenses appear when they're incurred. As soon as you create an invoice, it becomes income. As soon as a bill shows up for materials, you recognize it as an expense.

As with the cash method, there are pros and cons to operating on an accrual basis. One disadvantage is that you need to have a basic knowledge of accounting to understand your income statement. For example, you can appear to be profitable but not have any money in the bank. In accrual-basis accounting, profit does not equal cash flow. As a result, you must review your payables and receivables regularly to analyze your cash situation.

Another disadvantage is that the accrual method requires two steps to

process payments to vendors and subcontractors. With the cash method, you don't have to do anything until you're ready to pay the bill. Under the accrual method, you have to make a bookkeeping entry to create a payable as soon as the bill arrives. When it's time to pay the bill, you write a check and make a corresponding entry to cancel the payable.

On the other hand, this two-step system allows you to recognize expenses earlier, because the payables account holds expenses that have been incurred but not yet paid. This makes it more likely you will detect problems while there is still time to fix them.

More Pros than Cons

The advantages of using an accrual system far outweigh the added bookkeeping costs. An accrual system makes it much easier to manage your company with an eye towards profitability.

An income statement covers a set period of time, usually a month, quarter, or year. But construction jobs don't all start and end on the same date. A typical construction company works on several jobs at a time. The income statement combines all the jobs and shows the profit or loss for the company as a whole, but only for a given period of time. It can measure your true profit only if it's based on dollars earned and expenses incurred. The statement will not reflect reality if it's affected by arbitrary decisions such as when you write the checks.

For example, if you had \$50,000 of income from a job and had written checks for \$35,000 in expenses, you would appear to be making a profit of \$15,000. On a cash basis, that's what the income statement would show. But if you still owed \$5,000 to your vendors, the actual profit would be \$10,000. This is what the statement would show on an accrual basis.

Overhead can cause problems too. On a cash-basis financial statement, one month could show twice the normal

rent expense because you printed two checks, one on the first day of the month and another on the last. The following month you may have no rent expense. It's hard to analyze your overhead or profit when the numbers jump around this way. With accrual accounting, the expense occurs monthly whether you write a check or not. If the profit level of your business fluctuates, it's because something real happened, not because a deposit was made or a check was written on a particular day.

If you do T&M work, accrual accounting can enhance your cash flow. Instead of invoicing the client when you pay the bills, you can enter the bills in the system and generate an accurate report that you can use to invoice the client. When you pay subs and vendors, you can do it with the client's money, not your own.

Flexible Tax Law

If you're running a sound business, your accounts receivable balance runs higher than your accounts payable. That is, your customers owe you more than you owe your subs and suppliers. In this situation, there will be a tax benefit to using a cash basis because it will guarantee that you pay taxes only on the dollars you have actually been paid.

However, it's perfectly legal to use one accounting system for your financial statements and another one for taxes. There are some definite rules about doing this, so you should check with an accountant first. You can keep your books on an accrual basis and have your accountant convert them to cash for the tax return. This will minimize your current tax burden while making it possible to understand the true profitability of your business.

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Finding the Best Remodeling Customers

by David Lupberger

As a remodeler, time is without a doubt your most valuable and limited resource. There are only so many hours in the day, so it's critical that you use your time in ways that produce the best outcome for the company. You need to focus on high-impact activities — actions that create positive results in many different areas of your business. Understanding how to attract and qualify the right clientele for your company definitely fits into this category.

Audition the Client

The start of the sales process is a lot like an audition. In a scenario most contractors are familiar with, the homeowners call three or more builders and ask them to do a professional estimate while at the same time

not telling them exactly what they have to do to get the job. Then, after all that effort, a winner is chosen based on a criterion that's never been fully disclosed to the auditioners.

What if you could change this model? What if you auditioned potential customers to see if they would be a good fit for your company?

For small contractors, it's critical that you accept clients who are going to work well with your company. You want customers who are going to be enjoyable to work with and who share your ideas of what's important in a good working relationship. A good qualifying process will help you identify those clients.

You need to find out as much as you can about your prospective clients and

their project during your first contact with them so you can quickly weed out the ones who have a job that's too small, who are shopping for the lowest price, or who just aren't a good fit for your company and the service it provides. Once you've made the appointment with them, it's too late — you're already invested.

The Prequalifying Phone Conversation

An in-depth conversation sprinkled with questions is an easy, effective way to determine whether a caller is a good lead and to begin building a relationship. Don't rush your prospects off the telephone — spend 20 to 30 minutes or more. How much time you spend should be proportionate to the size of the job. A door replacement takes very little prequalification time, while a complex addition will require more.

When a potential client first calls and asks if you can help, the initial answer should always be "I don't know." Until you find out more about your potential customers and their project, you won't know if you can give them what they're looking for. Here are the questions you should ask:

1. How did the potential clients come to call you? Are they a referral from a previous customer? If so, this could be a "warm" lead that is already familiar with your work. If not a referral, how did they hear about you? Discovering where they got your name will begin to help you understand how serious they are about working with you.

2. How long have they owned their home? Part of the reason to ask this is to learn more about the homeowners themselves. This question allows the prospect to provide you with some personal

Questions you should ask

- 1. How did the potential customers come to call you?*
- 2. How long have they owned their home?*
- 3. What is the type and scope of the job?*
- 4. Why they are considering remodeling?*
- 5. What is their target schedule?*
- 6. What is their budget range?*
- 7. What level of research have they done?*
- 8. Who will be involved in the decision-making process?*
- 9. Have they ever remodeled before? If so, what was the outcome?*

history; a serious shopper will be open and willing to share this information.

3. What is the type and scope of the job?

This is where you begin to drill down to find out more about the project itself. Is it the type of project you like doing? Is it something you are good at and can do profitably? How many details can they give you? A serious prospect will share this information with you. There are certain jobs you don't want. This question lets you know if they have a project that fits the type and scope of work you do.

4. Why they are considering remodeling?

Why have they called you? Do they have any idea about what living through a remodeling project is like? I always like to ask the question, "Wouldn't it be easier to move?" It may sound unusual, but serious prospects have considered moving and have made the decision to stay and renovate their home. I want to understand more about their decision process and why the project is important to them. Serious prospects will have a straightforward answer to this question.

5. What is their target schedule? Before I go out to meet them, I want to know if they want to start their project in 4 weeks or 18 months. Knowing a homeowner's timetable will begin to tell you if you have the ability to give them what they're looking for. A homeowner's timetable rarely matches a remodeler's production schedule.

6. What is their budget range? Many remodelers don't feel comfortable asking this question in the initial phone call. And sometimes, homeowners are unwilling to share this information. But you still need to ask the question! You don't want to go on a sales call if the prospects don't have a realistic idea about the real cost of the project they

want. If you feel uncomfortable asking the question directly, try a "bracketing" strategy: If the homeowners have told you they want to redo their kitchen, let them know that you have done kitchens for \$25,000, and you have completed kitchens that have cost \$75,000. Ask them which range they are in — \$75,000 or \$25,000? If they tell you they are in the \$10,000 range, that may not be an appointment you want to go on. If they are still unwilling to share information about their budget, you need to find out why. Don't waste your valuable time with "tire kickers."

7. What level of research have they done?

Have they put much thought into the project they've called you about? How long have they been considering it? Do they have pictures or examples of what they want to do? Serious prospects have spent time researching what they want and will be able to share that information with you. This will help you in preparing materials for the initial appointment.

8. Who will be involved in the decision-making process? Before you make an appointment, ask who will be involved in making the decisions on the project they want. If there is a partner or spouse, make sure that both partners attend your scheduled appointment. You don't want to go on a sales call where one of the decision makers isn't present.

9. Have they ever remodeled before? If so, what was the outcome? You want to discover if they have any remodeling history. If so, ask them what their experience was like. Was it good or bad? What did they like and not like about it? This question will begin to uncover their remodeling "fears." If they had a good experience, you can start to build on that. If they didn't, you may want to ask more about what happened and why. Their answers will begin to tell you

if they are the type of client that you want to work with, or whether they have any "baggage" that could affect how you run the project.

Saying No Gracefully

Many companies have created a lead form that acts as a "crib sheet" — a reminder not to skip over pertinent questions. One firm I know rates their leads in four main areas: project location, type of project, customer's sense of urgency, source of lead. Leads scoring high get immediate attention; leads with a low score may be turned down.

If you decide you don't want a lead, be professional about how you turn the clients away. As an example, one Chicago firm I know tells the prospects, "We're a small firm and involve ourselves in a limited number of projects each year. Each project we do must fit what we do best. While this project doesn't fit our business, perhaps we could recommend that you call our association chapter and ask for their membership guide. There are many member companies that will be delighted to have your business. The number is Thank you for calling."

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