Setting Up an OCRA

by Michael Stone

Setting up an operating capital reserve account (OCRA) is one of the smartest investments you can make. It is an investment not only in your company, but also in your future. If set up and used properly, this account will:

- give you the ability to weather downturns in business and the economy
- let you walk away from a job you don't want
- protect you if unexpected bills appear — from vendors or the IRS
- protect you if you face an unexpected loss of income from a customer who refuses to pay
- provide coverage if errors occur in your bookkeeping or by your accountant
- help you take advantage of sales pricing on tools, equipment, and vehicles

Know Your Overhead

First, you need to know your average monthly overhead expenses. A good definition of overhead is all non-job-related expenses. If you do remodeling work, your overhead will normally fall between 28% and 34% of gross sales. Specialty contractors can expect their expenses to be a little less, around 22% to 26%, while new home construction companies will have overhead expenses in the range of 12% to 20%. Your numbers may be higher or lower than these, but the important thing here is to know what they are.

Next, you need to know your job cycle. A job cycle is the time expended from the first day of advertising through the day you collect the last payment for a given job.

Job cycle. To determine your average job cycle, calculate the length of time it took to do the last 10 to 12 jobs, add those times together, and divide the total by the number of jobs. We're after the average here, not the longest or shortest.

You need enough funds in your OCRA to cover the overhead for at least your average job cycle and maybe a little more. This gives you the cushion to advertise, do the work, collect the money, and get it into an account to pay your bills before you run out of money.

If you prefer not to use the job cycle approach, here's a good rule of thumb you can follow. If you are a specialty contractor, you should have a minimum of three to five months of overhead expenses in the account, preferably five. A general contractor doing remodeling should have a minimum of five to seven months, preferably seven months, of overhead expenses in the account. A GC doing new home construction should keep a minimum of seven to nine months, preferably nine months, of overhead expenses in the account.

Many builders say their capital reserve account is the main reason they've been able to sustain their company through hard times

Of course, some new homes and larger remodeling projects can run 18 to 24 months or longer. We have all seen new home projects that took three to five years to complete from start to finish. If you do jobs of that size, set the goal for your OCRA based on that extended period of time.

First Steps

Let's say that you have a small company and you are rolling along hitting your sales and production goals without too much trouble. Life is good; then you come across this article. You don't have an OCRA, so where do you start?

Let's make some assumptions: You will sell, build, and collect $340,000 this year. Your overhead is running 32% of sales, or $9,067 per month average. You decide you want seven months' worth of overhead in your OCRA, or $63,469, and you want to build that account over 24 months.

Let's do the math and see what kind of increase in sales this new account will require, and how much you will need to withdraw from each check that comes into your company to reach the goal.

If we divide $63,469 by 2 (for two years), we get $31,735, which is the additional amount you will need to make in each of those two years. If your existing overhead is $108,804 ($9,067 x 12) for this year and we add $31,735 to that amount, we get a new overhead expense of $140,539. If we divide that number by 32% (our overhead percent), we learn that you must increase your sales for the next 12 months to $439,184 ($140,539 ÷ 32%).

That means you must sell an additional $99,184 ($439,184 – $340,000) in the next year, or $8,265 per month, to provide the money for the new overhead expense.

The following year you must do the

math again and adjust your numbers so that by the end of the second year, assuming that you don't make any withdrawals from the account, you will have reached your goal of $63,469.

If you think that the increase in sales to reach your goal is more than you can achieve, then set the time period for building your OCRA for three or four years. If spread over three years, your increase per year would be $21,156 ($63,469 ÷ 3); over four years, your increase per year would be $15,867 ($63,469 ÷ 4).

Setting Aside the Money

How do you collect the money for this account? It should be considered part of your overhead and be treated as an overhead expense. It should be part of your markup on job costs to arrive at the sales price for your work. If you're on the two-year plan, you should allocate $8,265 ÷ $439,184 = 1.88% of each check you receive to your OCRA and no place else. If you want to build your account a little faster, then allocate 2% or even 2.5% of each check to the OCRA.

Remember, this is not a "new toys" account. This is money that is to be used for just one thing — to provide an immediate cash reserve in case an emergency of some kind hits your company. That's why I strongly recommend that this account require two signatures for money to be withdrawn. Withdrawals should not occur when the owner is in an emotional state; they should be thoughtfully planned and the money spent wisely.

When You Reach Your Goal

When you've reached your goal for this account, you can scale back your contribution to 1/4% or 1/2% from each check that comes into the company. But don't, for any reason, stop allocating something from every check that comes in. You can put the balance of the money you were spending into the profits category or give Christmas bonuses to yourself and your employees.

If you have to pull money out of the account for some expense — taxes or a new transmission — you can boost your contribution back to the 1.88%, and it should not affect your cash flow. The single most important issue here is to take a percent of each check that comes through the door and deposit it to your OCRA account. The sooner you start, the better, and once you start, you should never stop.

Three Cautions

First, I would not use this account to pay your normal tax bills. Keep your taxes in a separate account. This makes for cleaner bookkeeping. The account can be used to pay taxes, but only if there is no other source available for that payment.

Second, you should discuss this account with your CPA and consider all the tax consequences to you and your company before you start.

Third, do not use the OCRA to purchase tools, equipment, or vehicles, unless they have been budgeted. If they are not in the budget to buy, don't buy them.

Whenever I speak to groups of builders on business topics, I ask those present whether they have an OCRA, by whatever name. About 10% to 15% say they do, and not one has said that the account has harmed their business. Many say that the OCRA account is the main reason they've been able to sustain the company through hard times. Building the account takes time and discipline. But once you get started, it's easy. You'll be glad to have it when the going gets tough.

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