

# Successful Home Contracting



How to save thousands of dollars and get a better quality home by acting as your own contractor.

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# *Lesson Twelve*

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## **Funding and Cost Control**



Interactive LINKS are [BLUE](#) and [UNDERLINED](#).  
Click on them for additional information on the subject you are reading about.

## Where You Are In The Course

### **LOT**

- PHYSICAL* - Selecting the Lot
- FINANCIAL* - PURCHASING THE LOT

### **PLANNING**

- PHYSICAL* - PLANS AND SPECIFICATIONS  
PROJECT SCHEDULING
- FINANCIAL* - COST ESTIMATE  
CASH FLOW PROJECTIONS

### **CONSTRUCTION**

- FINANCIAL* - FUNDING  
COST CONTROL - JOB COST ACCOUNTING
- PHYSICAL* - SUPERINTENDING  
DAILY SCHEDULING  
PURCHASING  
SUPERVISING AND COORDINATING THE  
CONSTRUCTION (QUALITY CONTROL)

## **SUCCESSFUL HOME CONTRACTING**

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## Overview

The lot has been purchased and the planning completed. We move now to the final major topic to be covered in this course - the *Construction Phase*. In the two previous topics (the *Lot* and the *Planning*), we have examined the *physical* element first, and then the *financial*. In looking at the construction of the home, we'll reverse that order and consider the *financial* portion first. In so doing, we'll be looking at two major topics:

1. *The Construction and Permanent Funding.*
2. *Cost Control* including *Control of Spending* and *Job Cost Accounting.*

Both of these topics will be covered in this lesson. In the last five lessons (13 -17) we will examine the *physical* portion of the construction process - getting it on the ground!

## WHAT YOU WILL LEARN IN THIS LESSON

- Sources of *Construction Funding* including conventional, government, and private sources.
- How the amount of the construction loan is determined.
- What a construction loan costs.
- How to shop for a construction loan.
- How to favorably impress a lender.
- What the lender will want to know about you.
- Exhibits you'll need when applying for a construction loan.
- Types of *Permanent Financing* available.
- How to *control materials costs* by having accurate takeoffs, by using purchase orders, by the proper receiving and storing of materials, and by controlling waste and theft.
- How to *control labor costs* by using the forms included to tie down your agreement and control change orders.
- The proper way to *pay subcontractors*.
- Procedures to follow when *paying for materials*.
- How to keep proper financial records and use the *Cost Accounting Forms* which are included.

## **CONSTRUCTION AND PERMANENT FUNDING**

Unless you have enough cash available to cover construction costs, you will probably be faced with getting a [Construction Loan](#) to fund the project and a *Permanent Loan* which you will pay off over 15-30 years. We say “probably” because it is possible to avoid construction financing if you build fast enough.

There was a builder in Oregon who developed a system of construction that allowed him to build homes from start to finish in *less than two weeks* ([Builder, November 1, 1981, p.42](#)). The homes were all "pre-sales" . . . that is, he had a contract on each home before construction began. He was ready to “close” on the home (complete the sale and get his money from the buyer) before most of the construction costs even came due!

Most of us, however, will not be able to duplicate that feat, and will thus be faced with securing the necessary construction financing.

### **SOURCES OF FUNDS**

Here we will examine some places you may explore in getting your financing in place.

#### **BANKS, SAVINGS & LOANS, VA**

There are many sources you may consider in seeking your construction funds. The most common source is a *commercial bank* or a *savings and loan association*. If you are a veteran, you may want to look at [VA financing](#). The terms are usually very attractive. For details, call your local VA office.

#### **FHA**

If your prospective home fits certain guidelines, it may qualify for an *FHA guaranteed loan*. These loans are available through approved participating lending institutions and are regulated by the Federal Housing Authority - a part of the Department of Housing and Urban Development (HUD). The FHA guarantee makes the lender feel a lot safer. An FHA guaranteed loan may carry a lower down payment and a lower interest rate. However, there is a price to pay. The FHA loan has a ceiling (upper limit) on the price of the home. Also, there may be a fee involved (called “points”) which will improve the yield of the loan - thus making it more attractive to the institution who will eventually purchase it from your lender. Finally, you will “pay” for a VA or FHA loan in the time and money it costs to have your home inspected during construction by a government inspector.

## **FMHA**

In certain rural areas, a home loan may be gotten from the *Farm Housing Authority (FmHA)*, which is administered by the Department of Agriculture. As in the FHA loan, above, the same kinds of advantages and disadvantages apply.

## **PRIVATE SOURCES**

Of course there are also *private sources* of construction financing. You may have an easier time convincing a friend or relative that you are qualified to contract your own home than you would a banker. You could pay a flat fee or an interest rate for the money. A good tactic is to offer more than they could earn on their money if it were simply sitting in a savings account. Once the home is completed, you should have no problem getting permanent financing (which is used to pay off the construction financing). This is because your own experience and abilities are no longer a factor. The home itself guarantees the permanent loan. Incidentally, *permanent financing* really isn't *permanent* . . . it just runs so long (30 years) that it *seems* permanent!

## **THE SECONDARY MARKET**

Perhaps you have heard or read about "*Fannie Mae*" loans. This is *not* a source for you to obtain construction or permanent financing. This cute name stands for the Federal National Mortgage Association, which is a stockholder-owned institution, operating under a congressional charter. It is engaged in the *secondary* mortgage market. That is, it will purchase your loan (mortgage) from your local bank and sell it to an investor like an insurance company or a pension fund for a labor union.

## **THE CONSTRUCTION LOAN**

If you are unable to obtain a combination loan (construction and permanent), which is discussed below, you will end up with two different loans - each with its own closing (and closing costs). Here is what is involved in a construction loan.

## **AMOUNT OF THE LOAN**

The first thing you and your lender will need to determine is the amount of money you need. You will already know this, of course, since you have done a detailed cost estimate and a cash flow analysis. If you followed the suggestions in Lesson One, you already know how much of a loan you can qualify for. The banker will still have to process your figures and scrutinize your plans.

### BASED ON THE APPRAISED VALUE

The actual amount of the loan will be based on the appraised value of the home (including the lot). The bank will probably use its own appraiser in determining this value. Bank appraisers are notoriously “conservative.” That means that they assign the lowest possible value to the proposed project. Remember, they want you to have a healthy stake in the project to make their investment safer.

### USING YOUR APPRAISER

If the bank will agree to using your appraisal, you may be able to get a larger construction loan by shopping around for a more liberal appraiser. The way to find one is by reputation. You can't just call up appraisers and ask them if they're liberal or conservative. They all just think of themselves as “fair.” Other builders and real estate brokers can tell you who the most liberal appraisers are.

### 100% FINANCING

On a construction loan, banks usually lend 75 to 80% of the appraised value of the home. If you own the lot, and it is worth 20% of the total package, you're in good shape. That's your “down payment.” The bank will lend you the other 80%, which includes enough to build the home and pay yourself the builders profit. Since this is more than you need to actually pay for the construction costs, you can either borrow less, or you can repay yourself for the cost of the lot and not have any of your own money in the home. *This is the 100% financing we mentioned in the introduction to this course (Lesson 1).*

### COST OF THE LOAN

There are several costs to you to obtain financing, which we include under the following two categories.

#### ORIGINATION COSTS

You have already addressed the different aspects of the cost of financing when you did your cost estimate. By way of review, we will mention here that there are up-front costs associated with the loan, which are in addition to the interest you will pay on the money you borrow. These *closing costs* involve the legal and administrative fees, recording fee, and loan fees or “points” that the bank charges to increase its yield.

#### INTEREST

Interest is charged for construction financing on the outstanding balance owed at a rate which is usually one or two points over the *prime rate*.

## **SHOPPING FOR THE LOAN**

From all we have said so far about getting your construction funding lined up, you may suppose that we have painted a picture of going to the bank, hat in hand, and more or less throwing yourself on the mercy of the lender! Far from it. This is a business transaction, pure and simple. This is how the bank makes its money. Don't forget that you are the customer. Don't deal with someone who doesn't treat you like one. You should actually shop several different institutions to see which has the best deal. The key areas you want to compare are interest rate and loan fees (points).

In many areas of the country the mortgage market is quite competitive, with commissioned salesmen handling most of the application process for permanent loans. As a person seeking to build their first home, you should probably try to deal with a loan officer rather than one of these salesmen. The salesman is certainly as well qualified as the loan officer to check your financial qualifications, but the loan officer may be in a better position to tell the bank's loan committee how well prepared you are.

## **APPLYING FOR THE LOAN**

Here are some important instructions you need to follow in actually approaching a lender and applying for your loan(s).

## **OVERCOMING A BANK'S RELUCTANCE TO GIVE YOU A CONSTRUCTION LOAN**

In many areas, getting a construction loan is more difficult than it used to be. This is because of the losses many banks experienced due to builder insolvencies during the last two recessions and the recent troubles experienced by the Savings and Loan community.

Bankers want to make money by earning interest on loans. They don't want to be in the construction business. So the banker will want to be satisfied that if he lends you money to build your own home, you will complete the task in an acceptable and timely manner, and produce a home that adequately protects his investment. That is, one that is structurally sound and aesthetically pleasing (resalable).

## **First Impressions**

When you contact lenders, impression plays a large role in how successful you are. Always try to work by appointment rather than just showing up. By all means, be clean and neat and well organized. Try to present yourself as a business person. It's OK to be excited about your new home, but try to give the impression that you can make rational, coherent decisions about it . . . that you are not running on emotions alone!

**HERE IS WHAT THE BANKER WILL WANT TO KNOW BEFORE HE LOANS YOU MONEY TO BUILD A HOME**

1. *Do you know what you are doing?* - If you are unable to carry the project through to a successful conclusion, the banker may have to step in and do it himself to protect his investment. So he will want assurances that you will have the knowledge required. *This course will provide that knowledge*, attested to by your *Certificate of Successful Completion*. He also wants assurance that the home will be properly constructed. If he has to take possession of the home at some later date - through a foreclosure for example (bankers always look at the worst possible case) - he wants a home that is saleable.
2. *Do you have an adequate "stake" in the project?* - The banker feels like you are less likely to simply walk away from the project should something go wrong if you have something substantial (financially) to lose. He figures you'll think twice before walking if you have some serious bucks on the line.
3. *Do you have adequate financial resources to carry it off?* - The banker knows that the draws will not always come in time to keep construction bills current. He does not want to be associated with a project that is plagued by tardy payments to subs and suppliers.
4. *Do you have adequate income to cover the permanent mortgage payments after construction is completed?*

**EXHIBITS TO TAKE WHEN APPLYING FOR YOUR LOAN**

**Overcoming Doubts By Being Prepared**

Since you are not a professional home builder, the banker will be looking at you very carefully. The best way to overcome the banker's doubts about placing his investors' money in your project is to be totally prepared and give every indication that you are knowledgeable and in control. The banker will scrutinize all of the *exhibits* associated with your loan application. These will include your own *Financial Statement* as well as the *Plans and Specifications* for the proposed home. He will also be using his *people experience* to size you up.

**Here Are The Things You Will Need To Take When You Approach A Lender.**

1. *Plans and Specifications* - Make sure they are as complete as you can possibly make them. The banker will determine the amount

that he will lend based on the *market value of the finished product*. The only way he can determine what that market value is to have a complete set of plans and specs. Make sure that a plot plan is included to show how the home will sit on the lot. Also, plan to have at least three crisp, new copies of the plans and specifications. Dirty, dog-eared blueprints make a very unprofessional impression.

2. *A Survey and Legal Description of the Lot* - The banker will be interested in the location, shape, zoning, and other aspects of the lot (see Lesson 2). He will also be interested in its value and the fact that you own it. The banker will not want to lend money to build a home on land that you do not own free and clear. He wants to be first in line should a foreclosure become necessary.
3. *Personal Financial Statement* - Make sure this is in a standard format - showing your assets, liabilities, and net worth. If you are working with only one bank, it may be good (or even required) to use their forms for the financial statement. Get your accountant to help you prepare it.

Make sure your financial statement is absolutely accurate. Don't try to hornswoggle a banker on a financial statement. He looks at them all day long. He's forgotten more about financial statements than you'll ever know. The banker is interested in your *real* position. If you're deeply in debt or you have to rely on things like personal jewelry and stamp collections to make your statement look good, you had better start looking for a co-signer with some *real* assets. Click [here](#) for a generic form you can use.

4. *List of Subcontractors and Suppliers* - This will demonstrate that you are serious, that you have done your homework, that you know what you are doing, and that you are ready to begin.

It may also be helpful to be able to tell the banker some of the builder references you have on each sub. Even though you may not be an experienced builder, the banker will feel better if he knows that the project will be carried out by experienced, competent subs.

At this point it may be better not to show your brother-in-law who used to work for a plumber as the person who will be do-

ing the plumbing on your job - even if you believe him to be totally competent! The banker will feel safer with someone who is engaged in residential plumbing every day.

Your construction loan will not be conditional on actually using the subs you present here, but don't be deceptive. If you do plan to use your brother-in-law to do the plumbing, be prepared to explain why you think he is qualified to handle the job, and have a professional lined up and prepared to step in should the need arise.

Use the *Form SC3* (Subcontractor Directory) on page 419 to organize your subcontractor information. In the next lesson you will find a Subcontractor/Materials Master List form (SC 10). It will be used to help you keep track of the subs and suppliers you are using on the project. We've found that it is very convenient to have them all down in one place.

5. *Materials Take-Off and Cost Estimate* - Again, this information, when presented on the forms we have supplied, will show that you are going about your building project in a very organized and professional way. Have photocopies of this material available to leave with the lender if necessary. Don't take your only copy. Review all materials before you go so that you are prepared to answer any questions that the lender may have. Don't be embarrassed if he asks you a question you can't handle. By this time, you probably know more than 80% of the small builders he deals with. Just admit you don't know, but that you'll find out.
6. *Construction Schedule (Critical Path or Bar Chart)* - Demonstrating your knowledge of the construction process as contained in your construction schedule will be helpful in adding further reinforcement to the fact that you are competent to contract your own home. Many lenders may never have even seen one of these. You can have a copy available if the question should arise. Otherwise, this is something you may not need to submit. But don't hesitate to show it.
7. *Certificate of Successful Completion* - This documents the successful completion of your course from the *Institute of Residential Contracting*, and is your proof of having formal training in residential construction. To receive your Certificate, you will need to complete the [Final Exam](#) when you have finished the course and return it to Home Building Answers.

### **OTHER REQUIREMENTS FOR THE LOAN**

The bank will also have other requirements associated with the loan. These may vary from location to location, but will usually include *adequate insurance* and one or more *surveys*. They will want you to carry a *builder's risk* policy which essentially protects their investment should the home burn down during construction. They may also want you to carry a certain amount of *liability insurance*. You should be adequately covered here, regardless of the bank's requirements. Talk with your insurance broker. They may even want you to have an account at their bank.

Once the bank has approved your construction loan, they will issue a loan *commitment*, which spells out all of the details. Click [here](#) to see a copy of a *Construction Loan Commitment* issued by a Florida savings and loan.

### **GETTING HELP**

If you have trouble getting the loan you require, you may consider several alternatives. If your problem is a weak financial statement, you may get a parent or friend to *co-sign the note*. If you cannot seem to overcome your lack of experience, you could try *teaming up with an established builder* to get the job done. His agreement to help keep you on track may be all the bank needs to clinch the deal. Or, you could actually get the construction loan in the builder's name. You could also use his credit with suppliers to purchase materials. You would probably want to pay the builder a negotiated fee for the use of his good credit - say \$500 or \$1,000. It would probably be best to set up a separate partnership rather than run this through his regular business. Otherwise his profit picture may be adversely affected (\$1,000 profit on \$80,000 gross income is pretty low).

Hopefully, you won't have this problem - especially because of a lack of experience. If one bank turns you down, try another, and another. Be persistent.

### **THE PERMANENT LOAN**

In addition to funds to carry you through construction, you may need to arrange "permanent" financing, which will allow you to amortize the cost of your home over a number of years. [Here](#) and below are some options.

### **THE "STANDARD" LOAN**

The typical permanent loan will be for 80-90% of the appraised value of the home, with a fixed mortgage payment for 15-30 years. An alternative is presented below. No lender will advance a construction loan until he has qualified you for a permanent loan as well. The details of permanent

financing are beyond the scope of this course, but are readily available from your mortgage banker.

### **ADJUSTABLE RATE MORTGAGE**

If you end up getting separate construction and permanent financing, you may want to look at an *Adjustable Rate Mortgage* (ARM) - sometimes called a *Variable Rate Mortgage* (VRM). Your lender may even be able to tie one of these into a *roll-over* situation (see below). The ARM has several features that may make it attractive to you.

#### **POINTS REQUIRED**

First, most ARM's require you to pay some "points" (money!) up front that will lower your interest rate for the first two or three years. This has the effect of lowering your payments for that period, possibly allowing you to qualify for a larger loan. Of course, this assumes that you have the ready cash to pay the points.

#### **FLEXIBILITY OF THE RATE**

Second, the interest rate, over the life of the mortgage, is flexible within certain limits. It can be raised or lowered to bring it into a fixed relationship (margin) with one of the established economic barometers (index). The advantage of this is that if payments go up later, it is assumed that you'll probably be making more money then and can handle it. On the other hand, if the payments go down, so much the better!

#### **OTHER FEATURES OF THE ADJUSTABLE RATE MORTGAGE**

Some of the subjects and concepts you should know about, and some of the factors you should compare when shopping for an ARM are:

1. Fixed and ARM Annual Percentage Rate
2. Adjustment Period
3. Index Used and Current Rate
4. Margin
5. Initial Payment Without Discount
6. Initial Payment With Discount
7. How Long Will Discount Last?
8. Interest Rate Caps: Periodic? Overall?
9. Payment Caps
10. Negative Amortization
11. Convertibility or Prepayment Privilege
12. Initial Fees or Charges

Your mortgage broker can explain all of the above and how each affects your Adjustable Rate Mortgage

### **A COMBINATION OR ROLL-OVER LOAN**

If you are dealing with a commercial lending institution (bank, savings & loan, etc.) rather than a private source of funds, you should try to arrange for a *roll-over loan*. Under this type of financing, your construction loan will simply become your permanent loan when construction is concluded. The terms may vary slightly under the permanent loan, but there will not be a separate closing (with its associated costs to you). Herein lies the big advantage of this type of financing.

## **COST CONTROL**

Controlling the costs when building your home will involve two areas:

1. Controlling the Spending
2. Job Cost Accounting

### **CONTROL OF SPENDING**

Control starts with a *spending plan* or *budget*. When you finish your *Cost Estimate* (Lessons 10 and 11), that's your budget! But how can you make sure that what you have planned is what actually happens? First of all, you need to understand that it probably won't . . . at least not exactly. Your Cost Estimate after all was only an *estimate*. Prices may change on some items between the time you estimate the job and the time you actually build. You may decide to make changes in design, finishes, or equipment that affect your estimate. You may find that the sub you had planned to use is busy and you have to use one who charges more. The point is to just be prepared for some variation.

As you learned when you did your *Cost Estimate*, there are two basic kinds of costs you will be involved in controlling - *materials* and *labor*.

### **CONTROLLING MATERIALS COSTS**

Controlling materials costs involves six items:

1. An Accurate Takeoff
2. Using Purchase Orders
3. Receiving Materials
4. Storing Materials
5. Controlling Waste
6. Control of Theft

### **ACCURATE TAKEOFF**

This was discussed and hopefully accomplished when you put together your *Cost Estimate* in Lessons 10 and 11.

### **PURCHASE ORDERS**

After budgeting (*the Cost Estimate*), the second step in controlling costs is to know what you are spending - *before the fact*. That means using *Purchase Orders*. Armed with the information in your *Cost Estimate*, you will be able to prepare your *Purchase Orders* accurately. You can get good all-purpose purchase orders at any office supply store. Using them will let you and the supplier know what you intend to spend. It will also give you a record against which to match the supplier's delivery receipt and invoice.

Using purchase order forms may sound very basic, but you'd be surprised how many builders do not bother. It takes a few minutes, but the effort is worthwhile - especially if there is a later disagreement about what was ordered and when. It is even a good idea to send a "confirming" P.O. after a phone order. Just fill in the purchase order as usual and mark it "Confirming telephone order to John Smith. DO NOT DUPLICATE SHIPMENT."

Your purchase order will show the *identity of the vendor* (supplier), *when* and *where* the material is to be delivered, and the *quantity, description, and price* of each item you are ordering.

### **RECEIVING MATERIALS**

You can use your copy of the purchase order as a *receiving document*. Just show right on the purchase order, the amount of materials you actually received. Here is the source of much disagreement between suppliers and builders. Builders often claim that they can't always be at the job site to count and sign for materials when they are delivered - and that is probably true. On the other hand, once the materials have been sitting on the job for some time, probably unattended, it is impossible to confirm what was actually delivered, should a question arise.

Here is a typical scenario. The framing package is delivered to the lot. No one is there to sign for the materials, so the driver just leaves the materials there and stuffs the delivery receipt under some boards. The builder comes by later, but doesn't check to see if everything that has been ordered was delivered. It's a lot of work to break the bands on a framing package, separate the materials by size and length, and count it all. Half way through the framing of the home, the framing subcontractor calls the builder and says he is going to need another 50 studs!

The builder's dilemma is that he doesn't know whether the supplier has shorted him or if he has had some theft. At this point he can only bite the bullet and order more studs. Of course, his takeoff may have been wrong, but that would be fairly easy to check.

From a stand point of cost control, the proper receiving of materials is a good practice to get into. This means being at the job site when materials are delivered and confirming what has actually been received before signing the delivery ticket. Just remember, your order was pulled and loaded by human beings, and human beings do make mistakes. If you have been shorted, make a note on the copy going back to the supplier as to the quantities you actually received. Have his driver sign for what he delivered on your receiving report (your copy of the purchase order). As soon as possible, notify the supplier of the discrepancy.

### **STORING MATERIALS**

Proper storage of materials can help control your costs. Have materials stored so that they are not damaged by weather or operations. Unused materials may often be returned for credit or a refund if they are kept in a resalable condition. So try to keep materials from being drug through the mud, stepped on, and splattered with paint.

### **CONTROLLING WASTE**

There will always be *some* waste on a construction job. It is impossible to order exactly the right number of pieces to build with nothing left over. But excessive waste is one of the real cost problems you'll have to try to control, if you are going to stay within your budget. Your major weapons in controlling waste are an up-front understanding with the subs that excessive waste will not be tolerated, and a vigilant eye to enforce your policy. Large or whole pieces of plywood, siding, or drywall dumped outside the home and 2 x 8's twelve feet long that are used for walk boards across muddy yards are a couple of examples of situations that should raise your ire. Have agreements with your suppliers that unused material in resalable shape will be taken back for a refund.



*It would be nice if all building materials were "stored" this nicely. Actually this is the framing package as delivered - before the shipping bands have been broken.*

(You may have to pay restocking charges).



*The carpenters have left and what a mess! This is **NOT** what we mean by the proper storage of materials.*

### **CONTROLLING THEFT**

The next item for consideration is to make sure that what you have ordered, and what has been delivered, actually gets incorporated into your home. That's hard to do if it gets incorporated into some nearby neighbor's basement. For some reason, many people seem to think that it's OK to "pick up" some of the "extra" materials at job sites. If you're not careful, you'll be stolen blind. Here are some techniques to help reduce theft.

1. Try to have materials delivered on the day they will be used. This is not always possible, of course. But when it is, do so.
2. Secure materials in fenced areas or storage facilities. As quickly as possible, get the home to the point where it can be locked up. Then you can use the home itself for securing valuable materials.
3. Talk to the neighbors. Ask them to help you keep an eye on the job while you are gone, to note the license number of anyone who looks suspicious, and to even call the police if there is obvi-

ous theft or vandalism going on. This is a good way to meet your new neighbors early on and to begin establishing a relationship of trust (if they're in charge of making sure you're not getting ripped off, maybe they'll be less likely to be the ones to be doing the ripping).

4. Ask the local police to drive by on a more frequent basis while you are at the highest risk. If you do experience a problem, report it at once. This will elicit better cooperation from the local police.
5. Post the property: "No Trespassing" and "Theft Will Be Prosecuted."
6. Carry insurance to protect yourself against excessive theft. We say "excessive" because there will be a deductible involved before the insurance company begins to pay.

### **PAYING FOR MATERIALS**

#### ***Matching Purchase Orders, Delivery Receipts, and Invoices***

Here is where your faithful efforts in properly receiving the materials pays off. If you've done a good job, you have a record of what was ordered and what you actually received. If you were shorted, the supplier was notified at the time of the shipment. So there ought to be agreement about what you owe. Carefully check the suppliers invoice against your records of what was received and what you agreed to pay on your purchase order. Report any discrepancies to the supplier at once. You should then pay the undisputed amount. Do not hold payment on the entire invoice to straighten out a \$5.00 disagreement. This will adversely affect your credit standing.

#### ***Cash Discounts***

Another thing you should pay close attention to when paying materials suppliers is *cash discounts*. Some suppliers allow you to deduct a percentage of the invoice if the bill is paid by a certain time - usually the 10th of the month. The discount is typically 2%, but can be as high as 5%. Taking advantage of these discounts can save some significant dollars.

### **CONTROLLING LABOR COSTS**

The second part of controlling your spending - after getting a handle on materials costs - is to control what you spend on subcontractors.

### **USING SUBCONTRACTORS**

We are assuming for our discussion here that you will subcontract most, if not all, of the work on your home. For that reason, traditional

labor considerations like man/hour estimations will not come into play. Rather, we will deal with the contractual arrangement between you and the subs. Just as the central tool for controlling *Materials Costs* is the *Purchase Order*, so the main tools for controlling *Labor Costs* are the *Subcontractor Agreement* and the *Change Order*.

### **SUBCONTRACTOR AGREEMENT**

It is important that you maintain a business relationship with subcontractors. The *Subcontractor Agreement* will help you do that. It is a contract between you and the sub. It spells out exactly what is to be done and the price you have agreed to pay. Make sure that you and the sub are clear on the subject of “extras.” This is an area where many people get burned. The Agreement should also specify who is furnishing what in the way of materials, tools, and insurance. It should address the question of the manner in which the work is to be accomplished - timely, workmanlike manner, in accordance with industry standards, etc. It may specify specific remedies for breach of the agreement, and touch on a variety of other subjects.

Your agreement should also specify when the sub is to be paid. With the exception of the electrician, plumber, and heating/air-conditioning people, you should not pay for subcontracted work until all of the work is completed. In commercial construction it is common to withhold a “retainage” of 10% for a certain amount of time even after the work is finished. This makes good sense, but is not common in residential construction in most parts of the country. Why would you want to do this?

### **An Example**

You pay a roofer to put the roofing on your home. He finishes the job and the work looks real good. Unfortunately, when the first rain comes three weeks later, you discover a big leak. When you call to get the roofer back out to fix the leak, you find he has moved to Florida. Great! Now you have to pay someone else to come in and perform the roofer’s warranty work.

On portions of the work which must be inspected (the footing, framing, electrical, mechanical, and plumbing), agree that final payment will be made only after the work has passed the inspection.

### **Form**

*Subcontractor Agreement* (Form SC1) is available by clicking [here](#). Generic agreements are available through office suppliers and blue printing companies. This is a legal contract. Have your (real estate) attorney look it over. You can change it to meet your needs.

### **CHANGE ORDERS**

It is important that you have a consistent way to handle changes in your agreements with subs. The [Additional Work/Change Order \(Form SC2\)](#) is a good way to control this facet of the relationship. Make sure that your subs understand that *nothing outside the original contract (Subcontractor Agreement) is authorized* or will be paid for unless the *Additional Work/Change Order* form is executed.

Then make yourself live up to it. Take the time to *get it in writing*. It will pay off in the end. This will not guarantee that you will not have misunderstandings with subs or disagreements over what was to be done, but it will help greatly. When you take the time to reduce something to writing, it shows the sub that you are serious about having an agreement that you both understand. It will discourage his coming back later with a totally different story.

### **OTHER CONSIDERATIONS**

Additional forms which may be used to help you get organized in dealing with your subs are available here.

1. The [Subcontractor Directory](#) (Form SC3). This form was introduced in Lesson 10 when we discussed finding subcontractors. It can be duplicated and kept in a notebook organized alphabetically by sub type - masons, plumbers, etc.
2. The [Subcontractors Information Sheet](#) (Form SC4) was also introduced in Lesson 10. It gives you a place where you can keep all of the pertinent information on each sub in one place. File these alphabetically by the sub's name or company name. We have found it handy to make a Subcontractor Book, by making multiple copies of this form and putting them in a three ring binder with alpha index sheets separating the various sub classifications (Electrician, Plumber, etc.).
3. The [Subcontractor Policy Statement](#) (Form SC5) simply lets the subs know about how you intend to do business. Not all builders use this type of thing by any means. SC5 is an example of a policy statement used by a Florida builder. Check with your attorney, accountant, and insurance agent when putting this kind of thing together. Include only those things which are pertinent to the way you want to operate. One thing you should insist on is that all of your subs carry their own *Workmens' Compensation* and *Liability Insurance*.

## **A WORD OF CAUTION**

Subcontractors are some of the most independent people in the world. Don't run them off with this form. *Be flexible*. Your intent is to get the job done, while covering yourself as well as you can. One thing the *Policy Statement* will do is to help build credibility with the subs. They need to know they are dealing with a knowledgeable person - not someone who just fell off the cabbage truck. If you decide to do something like this, give the subcontractor a copy and get him to agree to its terms before executing a *Subcontractor Agreement*.

4. The *Subcontractor's Statement* is used to establish a firm, recorded understanding that the sub is *self employed and responsible for his own taxes*. Have the sub sign this at the same time he signs the Subcontractor Agreement.
5. *Specific Lien Waiver* This is used to confirm in writing that the sub *has been paid what he is due* and that he will therefore not place any liens on the property. The sub should be required to sign this form at the time he is paid for his work. Liens are legal encumbrances that subs and suppliers can initiate against the property to collect for their work and materials. If you pay your bills, you shouldn't have any problems with liens. If an unjustified lien is placed on the property, see your attorney to get it cleared. The wording of the Specific Lien Waiver may not be exactly what is needed in your state. Check with your attorney.

## **PAYING SUBCONTRACTORS**

### **Before You Pay A Sub**

In most cases you will pay the subcontractors on the job site. Before paying a sub, carefully review the *Subcontractor Agreement* and any *Additional Work/Change Orders* concerning the sub. Then inspect the sub's work very carefully to determine if the sub has satisfactorily completed *all* of the work agreed upon. *Never* pay a sub for half-finished work unless you have agreed to do so before the job began.

### **Here Is A Typical Situation**

The framer approaches you on Friday afternoon. He claims to be 90% finished. He'll come back on Saturday morning and finish up. "It'll only take a couple of hours." Can you pay him Friday so that he can pay his men?

Being the good-hearted soul that you are, you agree. You even wisely hold back a little of his fee as insurance. Guess what happens. The sub doesn't show up on Saturday or Monday. When you finally get hold of him on Monday night you find out that his truck broke down on Saturday and that he had an opportunity for a big job, which in order to get, he had to be there on Monday. He says he'll come back the next Saturday and finish up your job. If you believe that, there's some ocean front property in Denver we would like to talk to you about!

So when you finally get another framing sub to come in to finish up the work, you find out that the previous one has left a mess. Not only have you been delayed a week, and are going to have to pay a premium to get someone to complete the work, but you are also faced with paying to straighten out the first one's sloppy work.

This kind of thing goes on all the time. You are not responsible for meeting your sub's payroll. You don't owe him until the work is completed. Be understanding but tough. Don't give in.

## **JOB COST ACCOUNTING**

Job cost accounting is where you are able to tell how well all of your planning and other cost control activities are paying off. This is the record keeping function.

## **TWO REASONS FOR KEEPING RECORDS**

First, you want to be able to keep up with your financial progress during construction. If you keep a record of your expenditures and compare them to your estimate as you go along, you may spare yourself some rude surprises. And *second*, you'll need accurate records for tax purposes.

## **ACCOUNTING SYSTEMS**

There are many systems of sophisticated construction accounting. If you are interested, we have mentioned a few references in the bibliography. There are also many construction accounting programs that will run on personal computers. You can find these through home builders publications like [\*Builder\*](#) and [\*Professional Builder\*](#), or through you local home builders association. What we are going to present here is a very simple method of keeping your records by hand.

## **KEEP EVERYTHING**

A good rule to follow is *keep everything* - all of your receipts, packing slips, assembly and operating instructions, warranty and service doc-

uments, etc. The paper you toss is the one you'll need . . . just as the garbage truck pulls away from your house!

### **COST ACCOUNTING FORMS**

We have developed some *Cost Accounting Forms*, which have been developed to help you manually keep track of expenditures. They include a column for the date you make a payment, the check number, to whom the payment was made, and 45 columns containing the *Cost Categories* we have been using (see the *Basic Cost Categories* in Lesson 10).

The forms are available in executable Excel format [here](#), or in PDF format that you can print and fill in by hand [here](#).

### **USING THE COST ACCOUNTING FORMS**

In the first row on each page, just under the title for each cost category column, write in the figure which represents your estimate for that category. You can get this information from the last page of your *Cost Estimate Form* (Lesson 11). Note: The first column on the cost accounting pages is simply a reference number for each line. By using these numbers it's easy to refer to a specific expense, like "the item on page one, line 14."

When you make a purchase for your home, just fill in the first three columns with the appropriate information, and show the amount spent in the same row and under the heading which best describes the expense. Periodically, perhaps once a week, you can total the expenditures in each column and compare the total to the estimate at the top of each column. This will give you a feel of where you stand.

On the next page is a sample of how your *Cost Accounting Forms* may look as you fill them out. You can see in the example that the builder came in under budget by \$38 on his *Design* and \$5 on his *Site Preparation* categories. He came in over budget by \$158 on his *Footings*, \$32 on the *Foundations*, and \$346 on the *Slab*. The other cost categories will have additional costs coming in, so he isn't sure how he is doing on those yet. The net overage is \$493 (\$536-43) at this point in the construction process. If coming in at or below budget on the job is critical, he may want to cut back somewhere else to make up for his overage to date.

Notice that the builder has included the cost of the *Foundation Survey* (line 19) and the *Builders' Risk Insurance* premium (line 20) under the *Construction Loan* (Column 3). This is where they were included in

COST ACCOUNTING			1	2	3	4	5	6	7	8	9	
#	DATE	CK#	PAID TO	Land	Design	Constr Loan	Permits	Utilities	Site Prep	Footings	Founda- tions	Slab
			<b>ESTIMATE</b>	12,000	300	3,500	100	3,500	250	500	1,000	1,850
1	6-23	1001	Royal Investments	500								
2	8-12	1002	Polk Soil Analysis				35					
3	8-13	1003	Polk Co. Health Dept.				5					
4	8-13	1004	Metro Design Service		258							
5	9-12	1005	First Federal of Athens			544						
6	9-12	1006	Bd. of Co. Commissioners				7					
7	9-15	1007	W. H. Barrett							200		
8	9-23	1008	Charles Pitts						245			18
9	9-26	1009	Cecil Davis									
10	10-9	1010	Cement Products, Inc.								683.81	
11	10-17	1011	First Federal of Athens			75						
12	10-19	1012	Edgar Concrete							455.50		
13	10-19	1013	Whit's Building Supply							12.13		
14	10-19	1014	Jeff Terris									125
15	10-20	1015	First Federal of Athens			638.40						
16	10-20	1016	Johnny Parham								347.40	
17	10-20	1017	Johnny Parham									627.44
18	10-21	1018	City of Athens					16.16				
19	10-22	1019	Alpha Engineering			32.50						
20	10-28	1020	State Farm Insurance			141						
21	10-29	1021	Rinker Concrete									1,425.70
22												
23			Totals as of 10/30	500	258	1,431	47	16	245	658	1,032	2,196
24			Over/(Under)	(11,500)	(38)	(2,069)	(53)	(3,484)	(5)	158	32	346
25												
26												
27												
28												
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the *Cost Estimate* (Lesson 11). If you wanted, you could total all of the column totals across all of the pages and get a total spent-to-date for the whole house.

As usual we have included a blank Cost Accounting Form (last page of the Cost Accounting Forms), so that you can customize it to your own requirements.

Admittedly, the Cost Accounting system included here is not very sophisticated. But you would be surprised to learn that many small builders do not even do this much. This is simply a decision making tool. It gives you some data on which to base spending decisions. If used faithfully, it will help keep you on track financially. And as we said above, if you want or require more detailed data, there are other systems readily available.

## Summary

In this lesson we have moved into the last major section of the course - the *Construction* phase. We began here with the financial component - learning what types of construction and permanent financing are available, and how to go about getting it. We paid particular attention to preparing you to make a favorable impression on the lender by being absolutely prepared - knowing what you're doing! We discussed some of the requirements the lender may impose as a condition to making a loan. And we looked at the advantages of getting a *roll-over loan*.

Then we examined the area of *Cost Control* and found that it is comprised of *Control of Spending* and *Job Cost Accounting*. After talking about the various aspects of controlling your spending (controlling *Labor Costs* and *Materials Costs* ), we looked at a fairly simple method of manually keeping up with your expenditures.

## Looking Forward

In Lessons Thirteen through Seventeen, we will be looking at the actual construction of your home, and teaching you how to orchestrate (superintend) the process of getting the home built. In Lesson Thirteen you will look at all of what is involved in superintending the construction project.. This will include the scheduling of subs and materials to the job site, dealing with subs, understanding building codes, working with inspectors, and much, much more.

Then we will begin a detailed discussion of the actual building process - what to look at, and what to look for, when you are at the job site. Your essential job here is to assure compliance with the plans and specifications and to oversee quality control in the construction process.

[CHECK LISTS](#)

[Q&A's](#)

[Return to Home-Building-Answers.com](http://Return-to-Home-Building-Answers.com)