To: Jeffrey T. Mezger
From: EY Accounting Services
Date: 12/8/2024
**Subject: Variances**

KB Homes is a U.S. based homebuilding company that designs and constructs customizable homes to meet the needs of diverse buyers. As a leading industry player operating across many markets, it is essential that the company maintains a precise budget to sustain efficient operations and meet growing demand. An inaccurate budget could severely impact KB Homes, eroding their ability to manage their costs and maintain profitability. If the budget fails to project expenses or revenues accurately, this can lead to insufficient capital for land acquisition/development, home construction, and delayed projects. This is why my team is here to help with the budgeting process of KB Homes and to explain any variances that might alert management.

We first started with finding out the actual results from 2023 through the use of KB Homes 10-K statement. Next, we then constructed the flexible budget, keeping the method of using actual home closing units (13,236) and budget selling price/expenses to derive the numbers. After creating the actual/flexible budget, we analyzed them further to see any variances that are potential risks to the company. Starting off with the static budget variance, we compared the results of the poorly constructed 2023 budget vs the actual results. The budget made for 2023 was constructed with no strategic goals/historical trends in mind, and simply copied the results of 2022. Due to actual home closing units being smaller, (4% decrease in the number of homes delivered from 13,738 to 13,236), home/land closing revenue was unfavorable of 499,256. On the other hand, financial services revenue increased and was 6,109 favorable. Overall, the static budget variance had a total that was unfavorable of 312,492.

Next, we analyzed the flexible budget variance. Though we are using the same home closing units of 13,236, the home/closing revenue variance is unfavorable at 247,841. This is due to a 4% decline in the overall average selling price of those homes to $481,300. KB homes had a decrease in selling prices for many reasons, such as heightened competition. KBH competes with other home builders on the basis of selling price and many more factors that give them a competitive advantage when they have a lower selling price. Heighted competition along with economic uncertainty led the company to reduce home selling prices or offer other concessions to attract or retain buyers, which they did selectively in 2023 (particularly, mortgage-related concessions such as interest rate buydown or lock programs), and they expect to continue doing this in 2024 to varying degrees, negatively affecting their revenues and margins. If there is an extended downturn in the U.S. housing market, this could result in an oversupply of new home and resale inventory and greater foreclosure activity, which would further impair KB Homes ability to sell homes at the same volume, price, and margins as in prior periods shown. When looking at the financial services revenue, this increased from prior period, with a favorable variance of 6,965. The financial services include the operations of KB HOME Mortgage company, which generates revenues from insurance commissions and title services. This growth reflected increases in both title services revenue and insurance commissions. The total revenue was unfavorable at 240,876.

When looking at the costs, our team noticed that actual costs of home/land closing and financial services were higher than budgeted (previous year) with a total unfavorable cost variance of 7607. Looking deeper, this was due to general inflation in the economy. Due to this, KBH experienced rising land and construction costs, particularly for building materials, construction service providers rates, and warranty repair costs. The company expects this trend to continue until the end of 2024. Our team also makes the assumption that due to supply chain issues that are still lingering from Covid, this could have led to higher expenses for sourcing materials. Regarding SG&A, we calculated an unfavorable variance of 25,457. This was largely due to higher marketing and commission expenses the company incurred. Marketing expenses in 2023 rose due to higher costs to support their higher average community count. Overall, the flexible budget variance has an unfavorable variance of 273,940.

Lastly, we analyzed the sales volume variance, which shows how the differences in home closing units makes a difference in profitability. The decline in the number of homes delivered reflected a 20% decrease in the West Coast homebuilding segment, and was offset by increases of 4%, 4%, and 2% in the Southwest, Central and Southeast segment. Due to the decrease in home closing, this drove down revenues and expenses of home and landing closing/financial services. We believe that this decrease in home closing is due to reasons such as economic uncertainty and interest rates. At the beginning of 2023, rising mortgage rates and inflationary pressures hurt consumers, reducing their demand for new homes. This trend was common across the housing industry, as higher borrowing costs impacted profitability for homebuilders. Another reason was due to supply chain/labor/geopolitical challenges. Due to the many disruptions in the supply chain, this may have slowed down construction timelines, causing less homes to be complemented within the year. Another reason for the decline is due to the impact of independent third parties. KB Homes depends on independent third parties to handle certain processes such as home closing, land purchases, and title insurers. In November and December 2023, two national title insurances experienced a cybersecurity incident that impaired their ability to provide these services. In return, this delays their land purchases and home closing transactions.

These factors significantly suppressed housing demand during the 2022 second half and into the 2023 first quarter. This led to a total of 252,271 unfavorable revenue for KB Homes. Being that costs are driven by units sold, less units caused a total of 190,711 favorable variance. Gross margin calculations resulted in 61,560 unfavorable variance. Regarding SG&A, we had a favorable variance of 23,008. Less home closing units equates to less commision/selling expenses incurred for the company, helping their bottom line slightly. The pretax operating income of 38,552 unfavorable. Though the results are unfavorable, we believe that economic conditions and stabilization of the supply chain will help the company increase their home closing units in 2024.

To: Jeffrey T. Mezger
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**Subject: Regression Analysis**

Our accounting team has forecasted a budget for KBH in 2024, including revenue, costs, and SG&A expenses. Data from the 2024 10-K report and market indexes were compiled and utilized in multiple regression analyses to project each of these line items, detailed below:

**Unit Sales:**

The purpose of this analysis is to estimate the unit sales, or number of home closings, for 2024 based on the relationship between ending backlog units (independent variable) and home closing units (dependent variable). Using a regression analysis, the forecasted number of home closings for 2024 is approximately **10,098.83.**

The regression model shows a significant correlation between the ending backlog and home closings, indicating that the number of homes yet to close is a reliable predictor of future home sales. This relationship suggests that as the backlog increases, the number of homes expected to close also increases, which is consistent with expectations in the housing industry.

**Home Closing Revenue:**

Home closing revenue is the amount of money received by the seller for the sale of a home. Our analysis found that the relationship between home closing revenue (dependent variable) and the home price index (independent variable) was strong, with a regression between the two variables resulting in an R Squared value of 0.88 and a P-value of 0.005.

Using the regression data, we were able to forecast the home closing revenue per home for 2024 to be $520.54.

**Home Closing Costs:**

Home closing costs are all the costs incurred while building a house including labor. We conducted an analysis of home closing costs, encompassing all expenses associated with building a house, including labor. Our regression model used Home Closing Cost Per Unit as the dependent variable and the Hourly Wages of Construction Workers, sourced from Statista, as the independent variable. We found that labor costs and closing costs per unit were correlated, which led us to believe that our projection is accurate.

Based on the regression results, we project the Home Closing Cost Per Unit to be $362.44 in 2024.

**SG&A:**

Selling, general, and administrative expenses include costs incurred from commissions, which is directly related to the amount of units closed during the period. As a percentage of revenue, SG&A falls at about 10%. A regression analysis was performed using data from the forecasted unit sales and selling price budget for FY24, evaluating the relationship between overall revenue (x-variable) and SG&A (y-variable).

The regression model found a strong linear relationship between the two variables, and provided a forecasted SG&A of **$545,475**. With unit sales projected to decrease by 15%, this is an appropriate forecast.

**FY2024 Budget:**

The final budgeted income statement was created by consolidating all the predictions from the regressions that were run, and also estimating the revenues and expenses related to financial services that KB Homes provides. The predicted values for these were calculated using past values present in KB Homes 10-K forms, calculating the average year-over-year (YoY) growth rate of both the revenues and expenses based on data from the past 5 years (2019 to 2023).

The pretax operating income overall has increased, regardless of the projected 15% decrease in units sold. This increase in operating income can be attributed to a more efficient cost structure, as well as an increase in the average price of home closings by around 6% in 2024 compared to 2023 values.

Overall, for the regression analysis done to calculate the predicted values for the budget, its important to understand that correlation does not necessarily mean causation, therefore there is the possibility that variances in the future actual values could be the result of factors that were not included in the models that predicted the budget. An example of a regression that was done that could have other factors influencing the regression coefficients, would be the regression of home closing units on ending backlog. Basing the regression entirely on backlog does not factor in that the rate of production, or number of homes closed could change in a given year. Not accounting for these variables could lead to a less accurate prediction.

While we can acknowledge that the regression models are not accounting for factors that may affect the prediction and that they have limitations, it's also important to realize that the predictive models are limited to what data is available, and that variances are expected to be present. The goal of creating a budget isn’t to necessarily predict exact values, but to give management a general idea of how a business is doing, and help them make data-driven decisions.

**Subject: RI and ROI**

KB Homes currently uses RI to compensate its managers, and uses the company as a whole for their benchmark. Our team believes that this is not an accurate benchmark to use to assess the division's performance. Primarily, the companywide RI is (72,681.68), showing that the company does not have enough net income to cover its cost of capital, which is not true. As shown in their 10k, the company has a net income of 590,177, showing that they are profitable and can cover their operations. When analyzing the RI, the reason why the outcome is negative is due to the huge amount of assets the company owns. Primarily, KB Homes is in a capital intensive industry, which requires substantial upfront investment in land, which increases the asset base. This land is recorded as an asset, even if its undeveloped land, land under development, or completed. Along with that, homes under construction are recorded as assets too, and are a heavy amount on their balance sheet as supply chain issues/supplier issues caused them to not finish homes as quickly as possible. To build their product, home builders own equipment, vehicles, and facilities needed for construction/operations, further contributing to the total asset amount of around 7,032,989. Overall, this industry has a long development cycle, and it is normal for KB Homes to have a lot of assets. This causes the companywide RI number to be skewed, and doesn't reflect the profitability of the company.

When looking at compensating segment managers with a bonus, all divisions from West, Southwest, Central, and Southeast all receive a bonus based on the RI. In reality the divisions could be doing worse than companywide, but are being compensated which hurts the company's bottom line. Management could think that the division managers are working very hard and achieving company goals, when in reality they could be slacking off and this would go unnoticed. KB Homes must change this benchmark so that they can get more accurate results. We recommend that they change their benchmark for RI to region specific.

ROI is a better measure for performance evaluation. KB Homes companywide ROI is 10.97%, showing that they are profitable in their investments and that their investment exceeds the costs incurred. It also shows how KB Homes was very efficient in creating a return with their investments (assets). Looking at each division's ROI, Southwest, Central, and Southeast would receive a bonus but the West Division wouldn't. This makes sense as KB Homes indicated that they struggled with the West Coast Division this year. West Coast homebuilding reporting engagement had a 20% decrease in the number of homes delivered year over year. Along with that, the development process in the West Coast home building is typically longer than other segments. This is due to municipal and regulatory requirements that are generally more stringent in California. Due to this, this slows down their process, and causes the segment to have less revenue/operating income. Another reason why is the lower average selling price the West Coast Division dealt with. This price reflected product and geographic mix factors, along with pricing adjustments and other concessions we selectively extended to buyers. Our team recommends for management to establish ROI as a company measure for performance evaluation. Using ROI accurately reflects the companies profitability and all the divisions performance. The company should keep in mind that due to the asset attentive nature of the business, it might push down the ROI calculation even if the company is successfully carrying out their operations. The company should move forward on giving the managers discussed a bonus.