



What's Your Daily Overhead?

by Jonathan Blaney

The most common method of job pricing uses a fixed mark-up on direct costs. A fixed percentage is added to the direct costs to cover overhead and profit. This is the technique Paul Hentzen discusses in his article "Mark-up Basics," in *NEB's* January 1988 issue. While Hentzen has shown an annual profit for twenty-five years, this does not necessarily mean that his technique will work for everyone. Reliance on past results as a predictor of future events is risky at best. Indiscriminate use of averages can be disastrous leading to cross-product subsidies and distorted job costs. I strongly recommend another method.

First, it is important to recognize that costs must be apportioned over the periods they benefit. An annual insurance policy, for example, which might be paid for over a six-month period is not free for six months and expensive for six months. Insurance is more accurately viewed as having a cost per year, per month, or perhaps best, a cost per day.

Like insurance, most indirect costs, which are frequently lumped together and called "overhead," can be analyzed in the same manner.

The first step in the "daily-rate method" is to determine your indirect cost for a year. Consider each cost element separately and in detail just as you would estimate quantities of different nails to be used on a project. It may be helpful to think of this budget as a cost estimate for a year-long project, excluding materials and labor. The total is the cost of being in business—an estimate of what would be lost if there were no sales all year.

The first time this budget is prepared it may take some time. However the initial input need not be repeated—you will merely build and edit this listing in future years.

The next step is to estimate the number of anticipated working days for the next year. Adjustments must be made for holidays, vacations, and bad weather. Overly optimistic estimates can cause problems and be costly. Be realistic!

Now calculate the indirect cost per day, the "daily rate," by dividing the annual cost by the total number of workable days.

Use this daily rate to estimate the total cost of a job. Multiply daily rate by the number of days necessary to complete the job, then add it to the direct cost to yield total cost.

The next step in the process is to budget profits. Set your dollar profit goal and, like indirect cost, calculate a daily rate. Now price any project: Direct cost plus indirect cost (daily rate x project length) plus profit (daily rate x project length).

To evaluate these pricing assumptions compare with the results of the mark-up-on-cost method of pricing by others, or by re-pricing past projects. If the daily-rate method prices are irreconcilably different from the mark-up prices, consider these areas. Are these average jobs or are they examples of high (or low)

relative materials cost? How does the profit goal compare with prior years' actual profits? Are indirect costs consistent with your sales volume? Are the estimates reasonable?

The daily-rate method will sometimes produce a price equal to the mark-up method. But it is the many occasions when the price is different that are significant.

The objective is to cover costs and make a profit on every project. The daily-rate method always covers all indirect costs and provides for adequate profit in relation to the duration of the job. A percentage mark-up does not always achieve these goals.

The total indirect cost of a project bears little relation to the dollar amount of direct costs and is instead clearly a function of time. It may be useful to calculate a daily rate per man if multiple jobs are going on at the same time. Most people naively accept that two men working for four days cost the same as four men working for two days, both eight man-days. This however is false, because indirect costs for the two men are twice what they are for four men (two days versus four days at the daily rate). Optimizing work force size will minimize indirect cost per project which translates into increased profits or allows lower pricing.

The daily rate method is a plan, the percentage-on-cost method is a guess. ■

Jonathan L. Blaney is a reader who lives in Wakefield, R.I.