VIEWPOINT

How to Charge for Overhead

We builders are a whole lot better with our hammers than with calculators. One example is the difficulty we have figuring out how to adequately cover our overhead expenses. How do we charge the customer for costs that aren't directly related to their particular job? Should we mark up labor and materials? Subs? How much? Should we tell our customers how much markup we apply?

by Les Deal

To price fairly and cover your operating costs, make overhead and profit a function of time on the job

Trying to find a way to charge the "right" amount for our craft seems a never-ending quest. Part of the journey is finding a way to charge for overhead that we can "buy into" — one that feels comfortable and is fair to all.

What Isn't Fair

I am convinced that using a single percentage markup for labor, materials, and subs is unfair. Sometimes it's unfair to the customer, sometimes to the contractor. The degree of unfairness varies from job to job — but it's always unfair.

Here's an example from a recent experience I had with a heating contractor who came to my house to make a repair. The service man was at the house for 20 minutes, and the actual cost of the part was $65. When the invoice came, it showed 1 hour of labor at $76/hour and a material cost of $130. Now I had no problem seeing the time as 1 hour; he needed to cover travel time. But I objected to the cost of the part being doubled, making the labor cost really $141 per hour. The heating contractor explained that the material cost was inflated more in this case because the job was so small. He pointed out that on really small jobs, where the material might cost only $5, he has to take a loss because he can't mark up the material enough to cover his costs. On the other hand, he said, if the material cost had been several times higher, it wouldn't have been inflated nearly as much.

Listening to all this, I began to realize that he hadn't a clue what he was doing. He was so heavily invested in trying to

make a percentage system work that he couldn't see how ridiculous the method seemed. It was evident that he had to calculate every job based on its own data and try to come up with a markup percentage that worked. In fact, he was shooting straight from the hip and had no clear idea of how much markup to apply.

There is really no reason for a contractor not to know what it costs per year, per month, per week, per day, or per hour to keep a service truck and employee in the field — or a fleet of 30 trucks, for that matter. The contractor should be charging the necessary hourly rate for every hour the company is in service to every customer. There is nothing mystical about it, and it takes no time to figure the invoice. Most important, it's fair to both the contractor and the customer.

It's About Time

I've used the system I'm about to describe for 20 years and am convinced that it's fair. What's more, it covers my costs and keeps me profitable.

In a nutshell, I charge customers their rightful portion of my annual overhead and profit, depending on how long their job takes to complete. Overhead is a factor of time, so the amount of overhead I charge to a job depends on how long the job takes.

My system is based on my knowing how much profit my company requires, and expressing it in terms of time. I take the Overhead & Profit number from my annual P&L sheet and convert it into dollars per hour. You could convert it to dollars per day or week, depending on how you want to work. I use dollars per hour, because that's how I think when bidding jobs.

I look at the last two to three years of annual P&L statements. From that, I can determine an accurate "budgeted" overhead for the upcoming year. I do the same for the annual profit. I add these together and divide by the total number of billed labor hours I expect to have in a year. This gives me the amount in dollars per hour that I need to charge in addition to labor for new work and service calls. I don't mark up material and sub costs.

I employ only lead carpenters in my remodeling business. I count all the employees' wages the same when calculating my markup, taking the hourly wage I pay for the highest-paid employee as the hourly labor cost for all the employees. There's not a big variation between individual wages on my crew. First of all, I don't hire "helpers," which means that I don't have any employees working at a much lower pay rate. Even though my carpenters don't all get paid the exact same amount, it's close enough.

In Practice

Here are some examples of my method in operation, using some of my company's numbers from a few years ago. We had an annual overhead and profit of $235,200. There were three field employees, who each put in 1,960 hours (49 weeks) for the year, for a total of 5,880 hours (1,960 x 3). Every hour each employee worked brought in $40 of overhead and profit ($235,200 divided by 5,880). Employee wages (including the expenses attributed to labor) totaled $25 per hour. Adding labor to overhead and profit yields $65 per hour ($25 + $40) as the amount my company needed to bid or charge per hour to meet the expenses of labor, overhead, and profit.

So, for example, say it requires one full week (40 hours) for all three of the employees to do a certain job (40 x 3 = 120). I bill out at $65 per hour, or a total of $7,800 (120 x $65). Of that, $3,000 covers payroll for the carpenters and $4,800 covers company overhead and profit. The money needed to run my company has nothing to do with materials and subs. So I bid the job at $7,800 plus material costs, subs, permits, rentals, and so forth.

I have had people accuse me of leaving money on the table by not marking up everything with a blanket percentage (a markup factor of 1.67 is often proposed). But if the purpose of my percentage markup is to ensure that I cover overhead

and profit, then I have to ask, "What money do you see 'on the table' that I am entitled to?" Sometimes we get into uttering phrases that we've forgotten the meanings of. I didn't leave anything on the table that was fair for me to have.

What About Risk?

So you ask, Where is the risk figured in? Good point. I figure risk based on the job at hand. It has nothing to do with percentage. By risk, I mean such things as the risk of callbacks, the difficulty of achieving what I "believed" I could do when I looked at the work, the degree of accuracy the mechanic has to achieve consistently in order to effectively do the work, the difficulty for me to orchestrate the work and subs, and the difficulty of correcting a possible error (repairing a cracked concrete shower pan is far more expensive than repairing an open joint in a window casing). I find that with experience, I can measure each of these things and assign a value in terms of the time it takes to do the work correctly to minimize risk. This is far more accurate than covering risk with a blanket markup percentage.

I can feel you cringe as you read this. But what if there are expensive materials on the job and something gets broken? Without extra markup on the materials, where will the money come from to pay for the breakage? In my 30 years in business, I have lost very few dollars to breakage. Poor workmanship by employees (callbacks) is another matter, but up to now that has cost me only $3,000 to $4,000 per year, or less than 1% of my gross. That's a significant sum, but even that has been too small to warrant figuring in a special percentage with the bids. It certainly would be unfair to charge two-thirds of the price of the materials to cover less than 1% risk. Marking up materials to cover liability is simply not warranted. Furthermore, I protect the home and the products we work with. I use the same subs over and over again, and they know what to expect. Do you budget extra dollars into your household grocery expenditures to cover the cost of potentially burning a good meal? I somehow doubt it.

Another Example

Let's look at a different example. What happens if the following week requires all three employees to do an extremely labor-intensive job with only $300 in materials and no subs? I doubt that I'm the only contractor who has had that kind of job. But using this system, everything is fine. It wouldn't matter if the job required no material or subs, because your overhead and profit aren't tied in with either. If you were bidding by percentage, how would you bid for that week? Obviously, using the 1.67 factor would leave you very short on money. So what value would you use instead? Would you increase it to 2, or 2.5? Or perhaps 3? How would you know what percentage to use? If you're like many builders, you may have nothing to base it on other than a guess, so you would likely end up being unfair, to either yourself or the customer.

Let's say the next job is also for 120 hours labor ($3,000), but materials and subs cost $5,000 each. Adding that all together equals $13,000 as the direct cost of the job. Now if I applied a factor of 1.67, I'd get a bid price of $21,710. Using my method, the price for the job is actually $17,800 (120 x $65 + $10,000). I can confidently charge $3,910 less than the guy using the 1.67 factor, win the job, and still know that my overhead and profit are covered. Life is good.

Here's a real-life example that is even more extreme. I had a customer who wanted a special kind of shower that was pre-plumbed with a water pump and lots of showerheads and included its own shower door. The shower unit cost about $4,500 wholesale, along with an additional $500 for other materials to complete the plumber's material list. The plumber could install it in one day using two employees for a couple of hours and one for the remaining six hours.

The plumber was into the percentage method and gave me a quote for 10 hours of labor ($650) and $7,200 for material,

for a total of $7,850. In other words, looked at from the customer's perspective, $5,000 for material and $2,850 for labor (or $285 per hour). Would you pay it? The customer didn't either; the plumber and I talked.

I don't object to a contractor charging what he thinks he's worth. What I object to is inconsistency. With a straight percentage markup method, you can't help but be inconsistent. Even though two customers hire your company for the same amount of time, one could end up paying more of your overhead and profit than the other. Being fair is not about being cheap. It's about treating everyone the same.

Marketing the Method

Using the labor markup system has also provided me with an excellent marketing tool. I tell every customer that there is no markup on materials. I also tell them that I can buy the same product they can buy at the Big Box, only my cost is lower and I'll pass the savings on to them. This long ago put an end to customers wanting to furnish their own materials. But if they raise the question, I have a good answer — an answer that puts me on the side of the customer. This gives customers another advantage for having hired me: They can upgrade to more expensive products and materials without feeling like they're paying through the nose for the upgrade. If they choose a $400 item instead of a $150 one, the extra $250 is actually spent on product instead of lining the contractor's pockets. This way you increase the customer's buying power, a nice bonus for the customer that doesn't cost you anything. You rarely find yourself in an adversarial position over material costs with this method.

The real issues here are fairness and accuracy. Overhead and profit are known numbers. You can budget overhead and profit. But you can't control them if you don't have an accurate way of bidding to ensure getting them. Labor is the best-known aspect of your company. However many employees you are set up with is likely the number you will have all year. Your labor hours will likely be the same next year as this year. If next year looks different for some reason, you can adjust the numbers accordingly. Likewise, you can budget a higher profit for next year if you found last year's to be inadequate. Attaching the overhead and profit to labor gives consistency and control to your business, ensuring that you'll have what you need to remain profitable.

Aside from the fairness issue, my biggest reason for using this method is that it makes it easy to give accurate quotes regardless of job size. We do a lot of small, one- to four-hour, jobs as filler between larger projects. By knowing what I need to charge per hour to cover overhead and profit, I can easily add up the hours, put in the travel time, throw in the material cost, and the quote or invoice is finished. Customers are always impressed with the fairness of the system, and they can tell they haven't been lied to about material costs. Even if the labor seems higher than expected, the bottom line doesn't typically seem unreasonable.

I know, I know — I can hear the protests. We all know that if you really charge the amount per hour required to operate, no one would hire you. You have to "mislead the customer" and put some of the cost on the material side to make it palatable. No! I say it's time to erase that myth from our minds. People are not stupid; they'll know you're misleading them. They have access to prices.

I've been using this method for 20 years. I am not poor. It works. My company consistently earns 10% to 15% for my salary and the same amount for company profit. And guess what? People respect my honesty. We work together in harmony. It is obvious to them that they are hiring me to be on their team, not as an adversary.

Les Deal *is a remodeling contractor in Cedar Rapids, Iowa.*

Editor's note: Have a viewpoint you'd like to share? Contact me at djackson@hanley-wood.com.