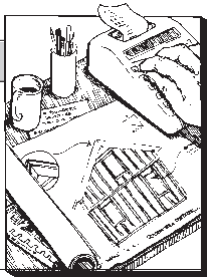


The Importance of Overhead & Profit

by Sal Alfano



If you want to keep your head above water in contracting, you need to understand the concepts of overhead and profit. Tracking these figures will enable you to make intelligent decisions about bidding, business expansion, and your company's financial health.

The year's end is a good time to sit back and reflect on these matters—

compensation is a percentage of payroll: the more employees, the higher the payroll, the bigger the premium. Your insurance agent should be able to give you a pretty good idea of what percentages apply in each case.

Other insurance costs, including coverage for vehicles, land and buildings, and tools and equipment, will

Common Overhead Costs

Insurance

Personal liability
Property liability
Workers' compensation
Motor vehicle
Land and buildings
Tools and equipment

Payroll Taxes and Benefits

FICA
FUTA and state unemployment tax
Employee benefits

Installments

Loans
Interest on capital
Rent and leases
Office maintenance

Operations

Legal and professional fees
Tool purchases and repairs
Consumable supplies
Vehicle maintenance
Office-help salary
Management salary
Callbacks

especially if December 30 closes out your fiscal year. An evaluation of the past year's finances can help you prepare accurate bids for spring.

Overhead

A builder has two types of costs: *direct variable* and *fixed*. Direct variable costs include every expense that is directly related to performing the work: materials, subcontractors, payroll, or a special tool rented for a single job. In other words, they include everything for which you have an invoice or a time sheet * billable to a specific job. These costs vary with the volume of work and with specific jobs. To keep things simple, I will call these *expenses*.

The other type of costs—fixed—commonly are called *overhead*. In the simplest terms, overhead is the cost of doing business. It comprises all of the indirect costs incurred by the

have fixed premiums as long as the equipment or real estate remains unchanged.

Payroll taxes and benefits are overhead costs that vary with payroll. FICA (Social Security) is based on a percentage of gross wages (currently 7.15 percent). It is withheld from an employee's paycheck, but is also matched by the employer. Unemployment insurance is usually payable to both state and federal governments, and, again, is usually a percentage of total payroll. Employee benefits include payments made to maintain a company health-insurance plan, or to provide for paid vacations.

Installments are regular payments made for business items, and are considered overhead. Don't forget the monthly or annual cost of keeping an office: rent, heat, electricity, and telephone. Other installment costs

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builder in running a business. Some of these costs—such as office expenses—are constant regardless of the volume of work. Others, such as taxes and insurance, vary as a percentage of expenses, but that percentage usually is fixed.

The first step in calculating overhead is to determine what your fixed costs are. While everyone's overhead will be different, the following review may be helpful.

Insurance. Personal and property liability premiums are generally a percentage of gross receipts. As the volume of work fluctuates beyond a certain minimum amount, so does the premium. Similarly, workers'

include interest on loans, and operating expenses.

Operations. Most costs of operation are self-explanatory. These include the costs of lawyers, accountants, and other professional services, and tool purchases and repairs.

Next, consider consumable supplies. These might include the cost of replacing drill bits or saw blades that wear out from normal wear and tear. Also in this category, count vehicle maintenance: registration, gas, oil, and upkeep.

Three other operation expenses are a little tricky. These include office help, management salary, and callbacks. Part- or full-time office help

should be considered overhead since this kind of labor does not involve the direct production of work and does not produce income.

Management salaries are similar in that a company manager does not produce income if he or she participates in the work only by selling and scheduling jobs, visiting the site, solving construction problems, and delivering materials. Most small builders do all of this and bang nails as well.

Whether you count your salary as overhead or as payroll—or split it between the two—is a major business decision. It will affect how you calculate overhead, how you bill jobs, and whether you make any money. Account for your time in a way that reflects your actual role in the business.

Finally, callbacks represent an operating expense, since work generally is being done with no new billing. You should try to determine the exact cost of callbacks from your records.

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In the meantime, something between 2 and 5 percent of gross receipts will work.

Once you plug in the numbers, the total of all of these fixed costs is overhead. Because overhead is relative to the volume of work you perform, it's useful to express it as a percentage of expenses. This percentage is the number you will then use to "mark up" the hard costs of construction in your estimates.

I want to throw in one monkey wrench here. Although employee insurance and payroll taxes are technically part of overhead, it's best to treat the total marked-up wages as an expense. This helps in billing for what workers actually cost you. This is especially important for cost-plus work where you must produce time-sheet records, and the amount you bill is directly based on man-hours on the job.

For example, if you pay carpenters \$10 per hour, you probably pay them closer to \$12 per hour after adding in workers' compensation (5 percent), FICA matching funds (7 percent), FUTA tax (2 percent), state unemployment tax (6 percent), and vacation pay (1 percent). (These percentages are fictitious.) In this case, employee overhead is 21 percent. So calculate your payroll overhead first, and include total marked-up wages as a part of expenses.

Profit

When all of your expenses and overhead are covered by your receipts, you have reached the break-even point. But just breaking even won't keep you in business very long. The missing factor, of course, is profit.

Profit is what's left over after all the bills are paid, including materials suppliers, subcontractors, wages, and

fixed overhead. But profit should not be allowed simply to happen, like an accident; it should be designed into the pricing structure.

Profit serves a dual purpose: it provides a reward for risk-taking, and it creates working capital for growth and a bridge over slack periods. Many small builders put most of their profit back into the business in the form of new equipment and personnel. Profit also keeps things going from season to season and represents a buffer against losses.

Profit is the most flexible of the pricing elements. The work costs what it costs, as does overhead, but profit can be whatever you choose, subject to market pressures. Selecting the right profit margin (profit as a percent of expenses) can make the difference between success and failure. It must be low enough to keep your pricing competitive, but high enough to perpetuate your business.

You must decide for yourself what a reasonable profit might be. To do this, you first have to determine what your overhead and profit actually are, and for this you must keep meticulous records. After a flurry of paperwork, you might discover something like this:

\$100,000 total direct variable costs
= expenses
\$10,000 total fixed costs = overhead
\$5,000 profit

\$115,000 total accounts receivable
= gross receipts

Calculating percentages:

overhead \$10,000
expenses = \$100,000 = 10% overhead

profit \$5,000
expenses = \$100,000 = 5% profit

If you haven't been paying attention to record keeping lately, you'll have to make your best guess. Your checkbook and bank statements ought to show what your gross receipts are, and you can determine overhead by collecting invoices for the appropriate items.

A few items, like callbacks, will require some imagination. You can approximate profit by calculating how much cash will be left over after the bills, including your own salary, are paid. Then perform the above calculations to determine percentages. (Remember that gross receipts differ from expenses in that the former includes—or should include—overhead and profit.)

Now all that's left is to project overhead and profit for the coming year.

Is business declining, staying level, or increasing? To find out, use the gross-receipts figures for the previous three years, and subtract your overhead and profit if you can. This leaves your expenses over a period of time. Is there a pattern? Consider the following example:

Expenses	Time period
\$100,000	2 years ago
\$125,000	last year
\$175,000	current year
?	next year

By simply figuring the percentage increase of expenses, you can see that last year increased by 25 percent, and the current year by another 15 percent. Next year might increase by the same amount: $\$175,000 \times 1.15$

= \$201,250. This, then, would be the basis for calculating overhead and profit.

But be careful. Many factors go into predicting how a business will go in the future, not the least of which is your ability to run it. Do you have enough employees to handle a 15 percent volume increase? Will your current equipment inventory be sufficient, or will you need to make major purchases?

Can you, as manager, handle an increased work load—estimating, scheduling, supervising, and billing—

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and still be productive on the site? Or will you have to increase overhead to account for time spent doing tasks not directly producing income?

These questions require a good deal of thoughtful analysis, but it's well worth the effort. The information you glean can then be applied to your pricing system.

We already have seen how overhead should be built into your payroll schedule. Your other fixed costs should be calculated as a percentage of anticipated expenses.

Again looking at our earlier example, if you anticipate expenses of about \$200,000 next year, and your current overhead is \$10,000 (and is likely to remain there), you need to figure 5 percent on every job to cover overhead. If you think your overhead might increase in the coming season to, say, \$15,000, then use a 7.5 percent markup. Don't pick a number out of a hat or a magazine. Find out what your real costs are and bid to cover them.

Finally, if you think you need \$10,000 in profits to make it all worthwhile, figure another 5 percent. Your anticipated ledger summary for next year will then look something like this:

\$200,000	expenses, including payroll
\$15,000	overhead (7.5 percent)
\$10,000	profit (5 percent)
\$225,000	gross receipts

These are, of course, only the basics. We'll explore the relationships between all of these elements in future columns. ■

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