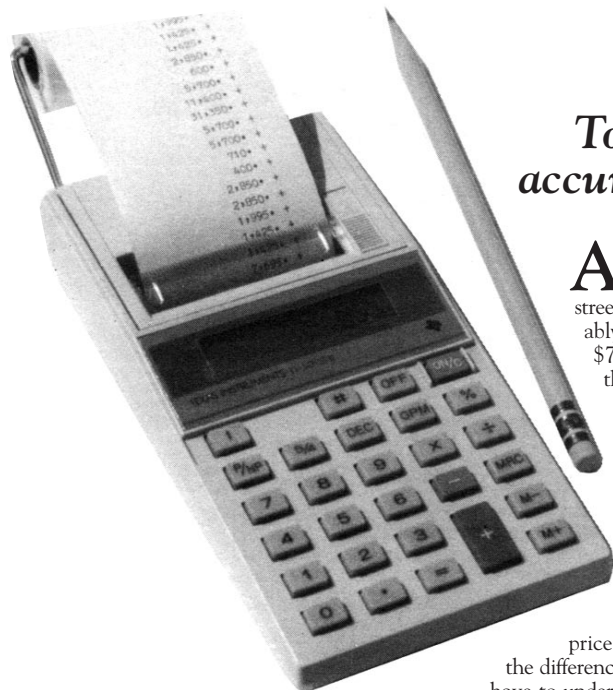


Keeping Track of Overhead

by Robert Criner

To make a profit, record your expenses accurately and calculate the correct markup



Ask the average small builder on the street what his net profit is and you'll probably hear something like, "Well, I made \$70,000 dollars last year." But, in fact, that number is probably what's left over after paying for materials, labor, and subcontractors. What most builders forget is that the cost of doing business still has to come out of that money. In other words, they forget about their overhead.

But even builders who know what their overhead is often confuse it with the markup they apply to get the final selling price for the jobs they estimate. To know the difference between overhead and markup, you have to understand the relationship between three basic concepts: *gross income*, *direct costs*, and *indirect costs*.

Cost Categories

Totaling up the dollar amounts for each of these three categories is the first step. You don't have to be a CPA to track these numbers. If you know how to keep a checkbook, you have what it takes to compile the figures you need. But this is precisely where most people fall down. They don't have a bookkeeping system that accurately records their company's expenses, nor the discipline to add up everything at the end of each year and look at the important relationships between income and expenses.

One advantage I have is that my remodeling business is small enough (\$300,000 per year) that I can keep an eye on all expenses. But my system for recording costs will also work for companies larger and smaller than mine. The basic idea is to set up specific cost categories and make sure that each expenditure or income transaction is recorded only once, in the proper category.

Gross Income

For small builders like me, income is simple. Most of the money flowing into my business comes from contracts, interest on my checking account, or discounts earned from vendors (see Figure 1). The total amount from these and all other sources is called *gross income*.

Direct Costs

Expenses are a bit more complicated and cause the most confusion. There are two kinds of expenses — *direct costs* and *indirect costs* — and you have to keep track of them separately to determine your overhead.

Direct costs are the most obvious. I think of direct costs as any expense I would not incur if I did not do a specific job. I keep track of five general categories of direct costs: permit fees, Home Owners Warranty (HOW) premiums, subcontracts, labor, and materi-

als (see Figure 2).

Labor includes more than just hourly wages. I also add up all the costs I would not incur if I did not have field employees. This includes social security tax, federal and state unemployment taxes, and all fringe benefits, like health insurance, vacation pay, and holidays. I also count workers compensation premiums as direct costs because they are linked directly to total payroll. I lump all these labor costs together for the purposes of job costing and calculating my overhead, but I keep them separate for tax purposes.

Indirect Costs

When you subtract direct costs from gross income, you are left with gross profit. Unfortunately, this is the number many builders quote when asked how much money they made last year. But gross profit doesn't go into your pocket. It includes expenses that represent the cost of doing business in general but that don't specifically apply to this or that job. These are called *indirect costs*.

Many of the indirect cost categories I use are self-explanatory and will work for almost any small builder or remodeler. The basic rule I follow to determine my indirect costs is just the opposite of the one I follow for direct costs: *A cost is indirect if I incur it whether or not I do any remodeling.*

For example, my own salary and the hourly labor costs of my part-time secretary are indirect costs because we work strictly in the office. If I swung a hammer part of the time or did direct field supervision, that portion of my time would be counted as a direct cost to the job. But my secretary and I work strictly in the office, and we work whether or not anyone is working in the field. It's true that we might not be employed very long if there were no remodeling jobs at all. But the point is that these personnel costs are not incurred by a specific project — the Jones or Smith job — but by the fact that Criner Construction exists as a business entity.

I treat general liability insurance premiums the same way because they're based on gross receipts and not tied to a single job. The same is true for office rent and utility bills, telephone charges, advertising,

Gross Income	
Amount	Source
\$281,865	Contract Income
3,135	Interest Income
=====	=====
\$285,000	Gross Income

Figure 1. Gross income is the total income from all sources. You might want to track income from different kinds of business interests separately. Then you can calculate your overhead for each kind of work you do, like new construction, remodeling, or a handyman division.

and all the rest.

A couple of indirect cost categories I use may seem puzzling, but they work for me because of the way I run my business. For example, I consider small tools an indirect cost because I supply all hand and power tools to my two full-time field employees. The tools are not consumed during the course of any single job, and the purchase price and maintenance costs are expenses I incur over a long period of time.

I also supply my field employees with company vehicles, and for the same reasons, their operating and maintenance expenses are indirect costs. The purchase price for large capital expenditures like this should be amortized over the expected life of the equipment. Otherwise it will throw your numbers out of whack. For example, if you pay \$12,000 cash for a new vehicle and include the total amount as an overhead expense in just one year, your indirect costs will be inflated for that year. Unless you expect to buy a new truck every year, you should divide the \$12,000 by the expected useful life of the truck — say five years, at \$2,400 each year.

Keeping Track

Once your cost categories are set up, it's important to make sure that no money is spent without being recorded. I have one checkbook and it never leaves the office. I have credit accounts with all my vendors, and I give every employee a charge card. This ensures that I have a canceled check, vendor invoice, or charge card receipt for every expense. On the rare occasions when a credit card isn't acceptable, I reimburse employees by separate check for out-of-pocket expenses and log it into the proper cost category. Once in a while I may have to run out with a check to pay for something in person. But I don't mind doing it because it's easier than losing track of the accounting.

Everything begins with estimating and job costing because you can't calculate your overhead without knowing what your direct costs are. When I do an estimate, I group the direct costs into 25 categories, such as "carpentry," "roofing," and "insulation." As the job progresses, I use the same 25 categories for job costing. I don't use a purchase order system, but whenever someone orders material, they include a job name and direct cost category. A load of framing lumber, for example, will be designated for the "Smith Job" in the "carpentry" category. If more than one category is required, they break it down right on the invoice. We try to keep invoices separate for different jobs. My field employees keep their hours daily and break them down the same way. All invoices that don't have anything to do with a particular job are recorded as indirect costs.

Stay Up-To-Date

At a minimum, you should update your record totals at the end of each fiscal year. But because the numbers in each category serve as budget figures for the coming year's expenditures, a monthly tally is better. Knowing what you spent last year on health insurance, for example, will give you something to compare this year's premium to. If the cost goes up, you can adjust your overhead to cover it.

I like to keep current with my books two or three times each week, so I always know where my business stands. It helps me to foresee problems, and it gives me time to react to them. Builders who don't keep track like this don't find out they're broke until it's too late.

Keeping good records also lets me pick and choose my jobs without the fear of not making enough money. I know that I have to make my overhead on every single job. And because I know what I need to make to cover my overhead, I can choose jobs that consistently provide that amount.

Good records also tell me which kinds of jobs my company is best equipped to do. We look for jobs where we can produce a superb product and get a good profit. If we can't be competitive on a job, we'll pass it up.

Overhead vs. Markup

Once you've made sure that all of your income and expenses are accounted for and distributed to the proper cost categories, you have all the numbers you need to find your gross income and direct and indirect costs. Now you can calculate overhead and markup.

Let's take overhead first. At the end of the year, when you total all of your indirect costs, you get a dollar amount that represents your overhead for the year. This is the amount you need to earn over and above your direct costs to cover the cost of doing business.

But the dollar amount for overhead isn't very useful when you're preparing an estimate. If you divide it into an average monthly amount and apply it to every job you estimate that month, you won't be competitive on small jobs and you'll be underpriced on larger jobs.

Because builders need to include indirect costs in every estimate, no matter how big or small, overhead is usually expressed as a percentage. *Overhead is the ratio of indirect costs to gross income.* Using the totals from Figures 1 and 2, the calculation looks like this:

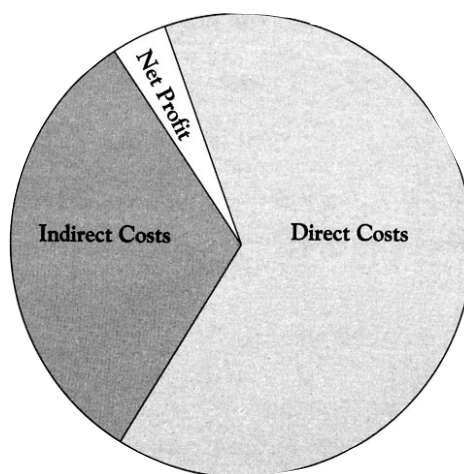
$$\frac{\$91,200 \text{ (Indirect Costs)}}{\$285,000 \text{ (Gross Income)}} = 32\% \text{ (Overhead)}$$

The most common mistake people make is to confuse overhead with markup. When they estimate a job, they figure the total cost for materi-

Breakdown of Gross Income

Direct Costs		
Amount	% Gross Income	Category
\$570	.2%	Permit Fees
285	.1	HOW Premiums
68,400	24.0	Materials
57,000	20.0	Labor
57,000	20.0	Subcontracts
\$183,255	64.3%	Total Direct Costs

Net Profit	
Amount	% Gross Income
\$10,545	3.7%



Indirect Costs		
Amount	% Gross Income	Category
\$1,995	.7%	Advertising
1,425	.5	Dues & Subscriptions
1,425	.5	Education
2,850	1.0	General Liability Insurance
600	.2	Legal & Professional
5,700	2.0	Medical Insurance
11,400	4.0	Office Rent
31,350	11.0	Office Salaries
5,700	2.0	Office Supplies
5,700	2.0	Part-Time Office Help
710	.2	Repairs & Maintenance
400	.1	Shop Expenses
2,850	1.0	Small Tools
2,850	1.0	Taxes & Licenses
1,995	.7	Telephone
1,425	.5	Travel & Entertainment
1,425	.5	Trash Removal
7,695	2.7	Truck Expenses
2,850	1.0	Utilities
855	.3	Work Clothes
\$91,200	32.0%	Total Indirect Costs

Figure 2. Direct costs are expenses charged against a specific job. Follow this rule: If you have this expense only because you are doing a particular job, it's a direct cost. Indirect costs are expenses you incur just by being in business. They cannot be charged against any single job, but they are necessary to keep the business going.

Figuring Your Markup

To cover this overhead	Mark up direct costs this much	Markup for every \$10,000 of direct costs
26%	35%	\$3,500
27%	37%	\$3,700
28%	39%	\$3,900
29%	41%	\$4,100
30%	43%	\$4,300
31%	45%	\$4,500
32%	47%	\$4,700
33%	50%	\$5,000

Note: For other numbers, use the formula:

$$\left(\frac{1}{1 - \text{Overhead}} \right) - 1 = \text{Markup}$$

For example: $\left(\frac{1}{1 - .34} \right) - 1 = .52$

Figure 3. Overhead and markup are often confused. Markup is always a larger percentage.

als, labor, and subcontractors — the direct costs. Then, if they know that their overhead is 32%, they multiply their direct costs by 32% to get their markup. For example, if they estimate the direct costs for a job at \$10,000, they add 32% of this or \$3,200 and quote the price to the owner as \$13,200.

That's just plain wrong. You lose money very quickly that way, and here's why. In the example, if your estimate is correct, you'll spend \$10,000 for materials, labor, and subcontractors (direct costs), and have \$3,200 left over to cover your indirect costs. Divide this by your gross income for the job (\$13,200) and you get an overhead percentage for the job of only about 24%. That leaves you 8% short of the 32% you need.

Instead, after you've estimated your direct costs, you need to multiply them by your markup to find the amount to add for overhead. *Markup is always expressed as a percentage of direct costs.* The mathematical problem you need to solve is this: What percentage of direct costs, when added to direct costs, will cover your overhead? In the example used a moment ago, the markup should have been 47% (\$4,700), which makes the selling price \$14,700. The \$4,700 is 32% of the selling price (the gross income for this job), and will just cover indirect costs:

$$\frac{\$4,700 \text{ (Indirect Costs)}}{\$14,700 \text{ (Gross Income)}} = \frac{32\%}{\text{(Overhead)}}$$

Figure 3 lists the percentage by which direct costs must be marked up to break even at various overhead percentages.

Profit

These calculations establish your break-even price — the selling price at which all of your costs (direct and indi-

rect) are covered, with nothing left over. But every business needs to accumulate some wealth to cover down times and finance capital expenditures, like new equipment. So you should include net profit in your markup. *Net profit is what's left after direct and indirect costs are subtracted from gross income.* My net profit is usually about 4% of gross receipts, which adds a little over 6% to my markup. In the example, a 47% markup covers overhead, and an additional 6% markup (\$600) takes care of profit:

$$\begin{array}{r} \$10,000 \text{ (Direct Costs)} \\ \times .53 \text{ (Markup)} \\ \hline \$ 5,300 \text{ (Overhead \& Profit)} \end{array}$$

The selling price for this job, therefore, should be \$15,300.

Common Mistakes

Most builders don't take a salary; they just draw from their checking account when they need to pay their bills. But not paying yourself is the biggest mistake you can make. All of the things you do in the office or after hours are necessary to the success of your company and should be accounted for as an indirect cost. Just because you're not banging nails doesn't mean your hours are less productive or less costly, in terms of overhead, than those of people in the field.

I bid everything on a fixed price because it means I never have to explain my overhead to clients. The minute you do that, you've lost the job because they will never believe you. They just can't fathom it, and no amount of explanation will change that. The best thing to do is bid your price and stick with it. ■

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