

# ARE YOU MAKING A PROFIT?

by Michael McCutcheon

I first learned something about profit when, after graduating from college in 1975, I worked for two years at a non-profit educational organization, earning a subsistence wage of about \$400 per month. Because I was used to being in college and living on the cheap, I thought this was adequate, since it paid for food and gas with a little left over (I had a free room at the time). When financial troubles forced the organization to reduce my wage to \$100 per month, I could no longer make ends meet. I quit and, having come from a family of contractors, I turned to doing small repairs for friends, and then for their friends, which is how I got into the construction business.

After a couple of years of regular work, I realized that in the two years I had worked for ludicrously low pay, I had actually dug a large financial hole for myself. I had deferred all sorts of things, like medical and dental treatment, repairing my car, and replacing my worn-out clothing. It took two years of earning "real" money to put a dent into this accumulated backlog. And it was several years before I finally made it out of the hole.

## Numbers Don't Lie

I soon learned that the same was true of my newly formed business. At the end of my first year as an independent contractor, I sat down with my accountant to figure out my income taxes. After adding up all my expenses, my accountant told me I had lost something like \$17,000 the previous year. I was shocked and amazed. "How can I have lost all that money?" I asked. "I

paid all my bills and I still had money left over in my checking account." He tried to convince me he was right by talking about depreciation, home office deductions, vehicle expense, and a slew of other overhead and operating expenses. But I just couldn't believe it.

Still, the experience stayed with me, and two years later I had the good fortune to attend a seminar on how to run a remodeling business. The instructor explained the concepts of overhead and profit. Using a chart of overhead categories, he explained how you need to keep track of these items every year.

I rushed home and did the overhead calculations for previous years, and the numbers convinced me that my accountant had been right: I was los-

ing money without knowing it. I immediately raised my prices and I have never looked back. The next year, my accountant told me I had made a net profit for the first time.

The financial hole I had dug for my personal finances is just what happens to a contractor who doesn't properly account for overhead and profit. The effects don't show up in the first month or year, but failing to cover your overhead and make a profit eats away at the heart of your business just as surely as working for subsistence pay undermines your household budget. The consequences are dire if your business fails, not only for you and your family, but also for your employees, your subs, your suppliers, and their families.

**Cash is not profit.** You can operate for a surprisingly long

period of time with cash flow only. As long as enough money comes in to pay the bills, the business seems to be making money. But don't assume you're making a profit just because you have some money in the company checking account. I will never forget the first time I deposited a big check into my business account. My client wired \$25,000 to get the job going while he left for a trip, and I thought I was rich. But the job turned out to be a turkey, and all the "profit" I'd been drooling over barely covered my out-of-pocket expenses. What I had in my account was cash, not profit.

**Gross vs. net.** There are two kinds of profit — gross and net — and builders often mistake one for the other. *Gross profit* is that portion of a

## Total Selling Price of Job



The largest portion of every \$100 of a job's selling price pays for direct costs — materials, labor, and subcontractors. Part of the remaining "gross profit" pays for overhead, such as administrative salaries, advertising, and insurance. What remains is net profit — what you actually made on the job.

*To make a profit, you have to pay yourself a salary, include the true costs of your employees, and use the right formula to find the selling price of your jobs*

job's selling price over and above the direct costs of construction (materials, subcontractors, and labor). For example, if a company does \$500,000 worth of work in a year, and direct costs are \$400,000, the gross profit is \$100,000 or 20% (\$100,000 ÷ \$500,000).

Unfortunately, many builders forget that gross profit must cover all of their overhead expenses — such as insurance, office rent, tool maintenance, and advertising — that are necessary to stay in business, but can't be assigned to a specific job. When you subtract overhead from gross profit, what's left is *net profit*. Net profit is "free and clear" of all costs related directly to construction, including payroll, vendor invoices, and subcontracts.

**Three common mistakes.** The symptoms of inadequate profit aren't hard to find. Do you have to scramble to make those large lump sum payments for workers comp and liability insurance at the beginning of each policy year? Are you sometimes unable to take cash discounts for prompt payment of invoices from suppliers? Do you sometimes fail to pay your employees, subs, and suppliers on time? If so, you're probably not earning enough gross profit.

Builders commonly make three mistakes that lead directly to this sorry state of affairs:

- They use the wrong formula to calculate the selling price when estimating a job
- They don't include their own salary (and that of other family members who work for the business) as overhead expenses
- They don't charge properly for the cost of their employees

## Selling Price

Using the wrong formula to calculate your selling price can make you believe you've built in enough gross profit when, in fact, you may not even be covering your overhead. When you estimate a job, you usually determine direct costs first — the cost of materials, subcontractors, and labor — then you add a dollar amount to arrive at the selling price. The amount you add is your gross profit, which should cover overhead and net profit. But many builders — even those who keep close track of their overhead expenses and know how much net profit they want to earn — charge too little for their work because they confuse the process of calculating overhead and profit percentages with the process of calculating the selling price. Here's how it happens.

Using the numbers from the previous example, let's say you did a total volume of \$500,000 last year, and your direct costs were \$400,000. The \$100,000 difference represents a gross profit of 20% (see Figure 1). Assuming that this is enough to

cover your overhead and still earn you the net profit you want, your goal for this year's estimates is to earn the same gross profit as last year.

Now imagine that you're estimating a single job that will take you all year to build — in other words, this one job will represent your total volume for the year. For simplicity's sake, let's say you've estimated direct costs at \$400,000 — the same as the direct costs for all of last year's work — and now you need to come up with a selling price that will give you a gross profit of 20%. But if you simply add 20% of \$400,000, you're only charging \$480,000 and you're losing money.

It's obvious that the selling price should be \$500,000, the same as last year's total volume. But why did the gross profit percentage yield a selling price of only \$480,000? Because the 20% represents gross profit calculated *backwards* from total volume. But when you work in the other direction (which many builders refer to as "marking up" direct costs), the same gross profit amount requires a higher percentage. This is always the case, because direct costs are always less than total volume.

The correct formula involves two easy steps (see Figure 2). First, subtract the gross profit percentage you need to earn from 100%. Then divide the direct costs in the estimate by the result. This will give you the proper selling price.

## Pay Yourself

You should pay yourself regularly an amount equal to what you would have to pay to replace yourself with an outside person who would perform all the same tasks. Some

| Calculating Gross Profit                            |                                               |
|-----------------------------------------------------|-----------------------------------------------|
| \$500,000                                           | Total Volume (all money received)             |
| – 400,000                                           | Direct Costs (materials, labor, subcontracts) |
| \$100,000                                           | Gross Profit (overhead + net profit)          |
| $\$100,000 \div \$500,000 = .20$ (20%) Gross Profit |                                               |

**Figure 1.** To find the gross profit for all jobs in a given period, subtract direct costs from total volume. To convert this number to a percentage, divide gross profit by total volume.

| Calculating Selling Price |               |                                                |                  |
|---------------------------|---------------|------------------------------------------------|------------------|
| Wrong                     |               | Right                                          |                  |
| \$400,000                 | Direct Costs  | 1.00                                           | 100%             |
| x 1.20                    | Gross Profit  | – .20                                          | 20% Gross Profit |
| \$480,000                 | Selling Price | .80                                            |                  |
|                           |               | $\$400,000 \div .80 = \$500,000$ Selling Price |                  |

**Figure 2.** If you use the wrong formula to calculate your selling price (left), you'll end up losing money. To correctly calculate the selling price (right), subtract your gross profit percentage from 100%, and divide the result into direct costs.

builders don't bother to pay themselves a salary, they just write a check from their account whenever they need to pay the bills. But unless you're always working in the field and keeping a time sheet, it's easy to overlook all of the hours you put into the business. If your salary doesn't show up somewhere in your overhead expenses, then you're paying yourself out of net profit.

For the sales and estimating work I do, I pay myself a salary of \$54,000 per year. This represents about a 5% commission on total sales. If I also did supervision, it would be worth another \$50,000 or so. A typical small contractor with an annual volume of \$250,000 to \$500,000, and who does all the office work,

should pay himself a salary for office work that's about 10% of total volume. If members of your family also do the office work, you should pay them salaries based on the market value of their services and include them as overhead expenses. And if you do additional supervision or carpentry work, you should pay yourself a fair wage for that as well.

## Charging For Labor

Many years ago, a contractor friend of mine was invited by an architect we both knew to bid on a bathroom remodel that I also happened to be bidding. My bid was \$37,000, but his was only \$27,000. Years later, when we were discussing business issues, he confided to me

| The Real Cost of Labor                             |             |             |             |             |
|----------------------------------------------------|-------------|-------------|-------------|-------------|
|                                                    | Owner       | Foreman     | Carpenter   | Laborer     |
| <b>Gross Pay</b>                                   |             |             |             |             |
| Base Wages                                         | \$54,000    | \$33,920    | \$23,744    | \$15,264    |
| Holidays (5)                                       | 0           | 800         | 560         | 360         |
| Vacation                                           | 0           | 1,120       | 880         | 600         |
| Adjusted Gross Pay                                 | \$54,000    | \$35,840    | \$25,184    | \$16,224    |
| <b>Labor Burden (Add to Gross Pay)</b>             |             |             |             |             |
| Insurance:                                         |             |             |             |             |
| Workers Comp*                                      | 1.26%       | 9.65%       | 22.25%      | 22.25%      |
| Liability                                          | 7.00        | 7.00        | 7.00        | 7.00        |
| Unemployment                                       | 2.80        | 2.80        | 2.80        | 2.80        |
| FICA                                               | 7.65        | 7.65        | 7.65        | 7.65        |
| Training                                           | .10         | .10         | .10         | .10         |
| Total Labor Burden                                 | 18.81%      | 27.20%      | 39.80%      | 39.80%      |
| <b>Cost with Burden (Gross Pay + Labor Burden)</b> |             |             |             |             |
| Annual                                             | \$64,157.40 | \$45,588.48 | \$35,207.23 | \$22,681.15 |
| Per Hour**                                         | \$37.83     | \$26.88     | \$20.76     | \$13.37     |

\* Based on California rates. \*\* Hourly rates based on 1,696 hours per year.

**Figure 3.** Your employees cost you more than the gross wages you pay them. When you estimate labor costs for a job, include the cost of holidays and vacations, as well as state and federal taxes and insurance.

that in those early days, if an employee was paid \$10 per hour, that's what he put in the estimate. He never included labor burden.

This amazed me, because this guy is very sharp and is now one of our most successful local contractors. If he was capable of this oversight, I wondered how many other low bidders out there were making even worse mistakes.

My labor costs take into account all of the expenses of maintaining employees, which collectively are called *labor burden* (see Figure 3). This includes items like liability insurance that are figured as a percentage of gross wages. Don't forget health insurance premiums, vehicle expenses, tool allowances and repairs, vacation leave, retirement plans, and other employee benefit costs.

Workers comp is also a part of labor costs, and there are a number of ways to reduce your rates (see "Straight Talk About Workers Comp," 2/93). For example, you can categorize the types of work performed to take advantage of lower rate categories. Also, in California, carpentry wages over \$19 per hour have a lower rate, and officers of corporations may exempt themselves from workers comp payments.

For the purposes of estimating, include labor burden as a direct cost. This will guarantee that all of the costs associated with having employees are covered. One disadvantage is that the added labor burden will make your hourly labor rates seem high to some of your clients, especially if your competitors don't include these costs in their estimates. To help your clients make an accurate comparison, provide them with a separate breakdown of the labor burden. Once they see how the added costs are derived, the only thing they can argue with is the base wage.

### How Much Profit Is Enough

The best way to decide how much profit you need is to review your company's finances regularly and analyze them for trends. For example, I determine which months show the highest volume of work and which show the lowest. I also compare the actual expenses of every job with the estimate. This helps with future estimates and tells me if I'm meeting my profit goals for each job. I recommend you look at your profitability from at least three viewpoints — by job, by month, and by year. Sophisticated contractors also look at profit from other angles, such as year-to-year, or by profit center (type of job).

**Figure overhead first.** Overhead consists of costs that are necessary to the operation of your company, but which can't be specifically billed to this or that job. Overhead

can legitimately be figured many different ways. For example, the cost of paper and toner for a copy machine can be billed on a per-copy basis to the jobs for which copies are made, or the total cost can be included as overhead. Exactly how you categorize expenses like these is not as important as being consistent and accounting for every expense.

The only way to know your own overhead is to study your company's past expenses. But if you have no such history, try to predict what your expenses will be. For example, a reasonable estimate of your anticipated payroll for the coming year can help your insurance agent determine what your insurance premium will be. Make informed guesses about other expenses, such as office rent, that are normally included as overhead. And don't forget to include your salary, or whatever portion of it pays for office work.

**Setting profit.** Most authorities I have read say you should plan for 10% net profit and expect to earn a little less. I used to shoot for 10% net profit and achieve about 7%; now I use 15% net profit as the goal. In the first year after starting this strategy, I made just under 10%; in the second year, largely due to the current recession, I showed a negative net profit. In other words, I lost money.

### What To Do With Profit

Natural variations in cash flow and volume of work affect overhead and profit numbers. This is particularly noticeable to me during my monthly analysis, but it applies to the yearly and job-by-job analyses as well. It's important to look at the averages over time to figure out what it all means. Don't get too excited if you have a very profitable first quarter. A first quarter profit is not a signal to go out and buy a bunch of fancy equipment or to give yourself a bonus. These things should wait until you have salted away a good amount in a company savings account. With an annual volume of a little over a million dollars, I like to have about \$100,000 in a business savings account (a money market fund currently earning about 3% interest) to act as a buffer in lean times. Additionally, I keep at least \$50,000 in the regular checking account to operate the business. In slow times, I draw down the savings to pay the bills, but when conditions improve, I always replenish savings before making new purchases or handing out raises. ■

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