



A SIMPLE SYSTEM FOR Turning a Profit

I'm new to the remodeling business, having just recently started my own company. Before that I worked as an attorney and accountant, so I knew about numbers, but I didn't know how they

by Jim Zisa

worked in the construction business. To learn about the real world of contracting, I asked two experienced contractors I know to lunch. As it happened, they had just worked together on the same project. Steve, a successful remodeling contractor with more than 20 years experience, did the foundation and structural work. Dan, the painting contractor on the job, has also become a "jack-of-all-trades" handyman to meet the needs of his loyal client base.

As our lunch progressed, the topic of conversation turned to profitability. It soon became clear that Steve and Dan bill for their work very differently. Steve is not the least expensive remodeler in town by a long shot, but the quality of his work is superb, and his prices reflect the value of the product he delivers. Dan, by contrast, works cheaply, stressing speed and turnaround time as the hallmark of a price-competitive business.

Selling Time and Talent

Steve got the conversation going by observing that, whether you build a simple deck or add a new wing to a mansion, you really bring only two "products" to the job: time and talent. These "two Ts" have value because they are unique and irreplaceable; no other builder can apply your time and talent as well as you can.

The two Ts have convinced Steve that the surefire way to cover all of your costs is to focus on billable hours. The ideal, as he explained it, is a year of full 40-hour weeks (less two weeks for vacation), or 2,000 billable hours per year. But since most contractors have some down time for weather, illness, and the like, Steve figures that the actual number of total billable hours is closer to 1,800 per year. While Steve pointed out that a self-employed contractor who works both

One way a small builder can make a profit is to include the cost of doing business in the labor charges

in the field and in the office would have even fewer billable hours, he suggested we use the 1,800-hour year as a reference point.

Breaking Even

To illustrate the concept of breaking even, Steve finds it useful to compare working for yourself to working for someone else. Since Dan had recently left a job as a carpenter to go out on his own, Steve used Dan's situation to make his point. As an employee, Dan earned \$17 per hour, for an annual base income of \$30,600 (\$17 per hr. x 1,800 hrs.). When Dan quit his job and went into business for himself, he raised his hourly wage to \$20 per hour — after all, he now owns the company and deserves to make more money. For 1,800 hours of work per year, Dan's total compensation as a self-employed carpenter is \$36,000.

Dan was quick to point out that he is making \$5,400 more per year than he was earning as an employee. Steve countered that this is misleading, since the new

wage does not take into account the time Dan will have to spend finding, estimating, and administering his own jobs, work that his employer used to perform. To make matters worse, the new amount covers neither the basic expenses of doing business — office supplies, phone service, and so on — nor paid vacations, sick leave, and other benefits Dan's ex-employer used to provide. To account for these added costs when calculating his total annual work hours, Dan either has to include the nights and weekends he spends in the office or cut his billable productive time on the site back to 30 or 35 hours per week so he can get his paperwork done during business hours. In either case, his true earnings are less than \$20 per hour, and Dan will have quit his job to become poor.

Beyond Breaking Even

To Steve, it was obvious from this scenario that the newly self-employed Dan must look *beyond* breaking even to the notion that he went into business for himself to earn a profit and not merely to work as his own employee. To do this, Steve continued, Dan has to account for two distinct cost components of his new business: compensation replacement and overhead cost recovery.

Compensation. Sketching figures on a napkin, Steve showed that because Dan now has to buy his own insurance, pay his own taxes, and fund his own vacations and retirement, he actually needs to make more than \$36,000 — nearly \$13,000 more, in fact — just to replace the compensation he gave up when he was an employee (See Figure 1).

Using round numbers, if Dan collects for 1,800 hours per year, he must charge his customers \$27 per hour ($\$48,600 \div 1,800$) just to replace his salary, benefits, and other costs directly associated with being an employee.

Overhead. But Dan also incurs additional costs directly related to running his own business. As an employee, for instance, Dan never had to buy his own office supplies, pay for a business phone line, or contribute his own association dues. Also, Dan has shop and equipment costs, such as brushes, drop cloths, ladders and scaffolding, that are directly related to his new business as a painting contractor. Assuming once again that there are 1,800 billable hours in a year, Dan needs to include these expenses as well as his salary replacement costs in his hourly rate. On another napkin, Steve showed that these costs might work out to an additional \$10 per hour, for a total billable “wage” of \$37 per hour (Figure 2).

Of course, Steve reminded us, these figures do not include costs for materials or subcontractors, which also get billed to customers; the \$37 per hour only represents charges for the two T's, Dan's time and talent.

Salary Replacement Costs

Base Salary (\$20/hr. x 1,800 hrs.)	\$36,000
Labor Burden:	
Social Security (7.65%*)	2,754
Health Insurance	3,046
Vacation (2 weeks)	1,600
Retirement (\$100/wk.)	5,200
Salary Replacement Costs	\$48,600

Labor Cost per hour: $\$48,600 \div 1,800 \text{ hrs.} = \$27/\text{hr.}$

*Note: To be consistent with what an employee would have to pay, only half of the total Social Security liability is shown here. Self-employed persons actually pay the full 15.3%.

Figure 1. The true costs of labor for a self-employed carpenter include labor burden — additional expenses that are typically covered by an employer.

Total Operation Costs

Salary Replacement	\$49,000*
Overhead:	
Fuel and vehicle expenses	5,000
Office supplies	2,500
Dues, seminars, etc.	2,500
Tools and equipment	5,000
Shop expenses	2,000
Total Operation Costs	\$66,000

Total Cost per hour: $\$66,000 \div 1,800 \text{ hours} = \$37/\text{hr.}$

*Rounded up from Figure 1

Figure 2. To determine the hourly charge necessary to cover the total cost of doing business, include all general overhead expenses in addition to burdened labor costs.

Billable Hours: Revenue vs. Expense (direct labor only)

Revenue (400 hrs. labor @ \$20/hr.)	\$8,000
Expense (labor plus burden & overhead)	14,800
Net Profit/Loss (revenue less expenses)	(6,800)

Figure 3. By failing to include labor burden and overhead in hourly labor charges, a self-employed carpenter actually loses money on every job.

Break-Even Hourly Cost

Base Wage	\$20
Labor Burden	7
Overhead	10
Equipment Replacement	2
Break-Even Hourly Cost	\$39

Figure 4. To break even on all expenses, a self-employed carpenter must add depreciation for the replacement costs for equipment, such as the purchase of a new truck every five years, to wages, burden, and overhead.

Billing for Profit

	Revenue	Expenses
Dan's Labor (400 hours @ \$39/hour)	\$15,600	\$14,800
Plus 10% Profit	1,560	0
Totals	\$17,160	\$14,800
Net Profit/Loss (revenue less expenses)	\$2,360	

Figure 5. Hourly labor charges should also include profit both to compensate for the risks of doing business and to provide capital to grow the company.

A Billing Comparison

Still suspicious, Dan asked Steve to apply this hypothetical information to the project they had just completed. Steve drew a simple table that compared his recommendations with Dan's actual labor charges and costs for the project (Figure 3, previous page). The numbers showed that Dan actually lost money on the job.

The numbers couldn't be right, Dan said. After all, he has \$8,000 in his pocket, so he must have covered all of his expenses. Steve countered that the \$8,000 wouldn't be in Dan's pocket for long. Dan's hourly charge of \$20 for his own labor was \$17 per hour short of covering all his costs, and sooner or later he'd have to pay out the additional \$6,800. That would leave Dan with just \$3 per hour for his time and talent, not nearly enough to cover his living costs.

Accounting for Overhead

Reflecting on what he just heard, Dan became very quiet, then said that he bills what he believes is fair. Steve replied that fairness has nothing to do with it. Running a business, he said, means making a profit.

And to make a profit, Dan must be aware of each and every cost of doing business — every paint brush, compressor, power nailer, hammer, and saw. Steve's rule is simple: If you have to write a check for it, you should recover the costs in your billings.

Grabbing the napkin with the numbers from Figure 2 on it, Steve reminded Dan that the costs of running the business, before receiving any compensation, are \$18,000 per year (\$66,600 - \$48,600). That means Dan has to bill \$10 per hour ($\$18,000 \div 1,800$ hours) just to cover that overhead.

Replacement of equipment. Steve then brought up another point: Nowhere did the numbers allow for the purchase of any major equipment, like a new truck. Somewhat glassy eyed at this point, Dan asked how much *that* would add to his rates. From yet another napkin sketch, Dan learned that if he needed \$18,000 every 5 years to replace his truck, he would have to add an additional \$3,600 per year to his business operations budget. Over the course of an 1,800-hour work year, Dan would have to collect another \$2 per hour ($\$3,600 \div 1,800$ hours) to pay for that new truck. This estimate of annual replacement costs, Steve explained, had to be included for all items that last longer than one year.

The Profit Factor

To determine Dan's actual break-even point, Steve started with Dan's base hourly wage of \$20, then added all of the additional costs (Figure 4). His conclusion was that if Dan bills \$39 per hour, he will break even in the truest sense of the expression and earn exactly \$0 for all his hard work.

But Steve still wasn't finished. So far, he noted, all we've covered is our costs; there is no reward for taking the risks of operating the business. To compensate for that risk, you have to add profit to the equation. In most cases, Steve explained, profit is determined by a combination of factors: the local economic environment, experience in reviewing jobs, typical markup trends, and a contractor's expertise and efficiency in actually performing the work. Steve argued that, all things remaining equal, the business environment supports, and a general contractor should strive for, a profit of about 10%.

Together, we applied this new information to the just-completed job, and arrived at some very interesting results (Figure 5). Had Dan accurately billed the customer for his actual costs of being in business (\$43 per hour), he would have fully recovered his overhead and earned a tidy profit as well.



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