Five Reasons Contractors Lose Money

by Sal Alfano

The phone is ringing off the hook, you're keeping twice as many subs and employees busy as last year, and you're booked for the next nine months. So why aren't you making any money? The answer may be simpler than you think. Here are five common reasons contractors big and small find their companies in the red.

Bad Math

A surprisingly large number of remodelers lose money because they miscalculate their selling price. They assume that their gross profit percentage is also their markup multiplier.

It's not. To see what I mean, imagine a job where direct costs — material, subs, and labor — are, say, $1,200. Let's also assume that you need to earn a gross profit of 33%. To find the selling price, many remodelers incorrectly multiply $1,200 by 1.33, and sell the job at $1,596. Unfortunately, that's $195 shy of what the job ought to be sold for. Not much on this little job, but over the course of a year, it adds up. On a total sales volume of $250,000, for example, you're cheating yourself out of more than $40,000.

There are two simple solutions to this problem. You can use a "Markup Multiplier" chart (see Figure 1), or you can abandon multiplication and use division instead. Divide estimated costs by the inverse of your gross profit percentage. In the example, divide $1,200 by .67 (1 – .33) and sell the job for $1,791.

Markup Multiplier

To earn this gross profit	multiply direct costs by this number
20%	1.25
25%	1.33
30%	1.43
35%	1.54
40%	1.66
45%	1.82

For other gross profit percentages, use this formula:
1 ÷ (1 – Gross Profit) = Markup Multiplier

Example: Gross Profit: 33%
Multiplier: 1 ÷ (1 – .33) = 1.49

Figure 1. To calculate selling price, find your target gross profit in the first column, then multiply estimated costs by the corresponding multiplier in the second column.

True Cost of Employees

Tax or Benefit	Cost as Percentage of Base Wage
FICA	7.65% (15.3% if you're self employed)
FUTA/SUTA	1% (federal and state unemployment tax)
Worker's Comp	10% (varies by state and trade classification)
Health Insurance	12% (based on $5,000 per employee per year)
Vacation	4% (2 weeks paid vacation)
Holidays	2% (6 major holidays)
Personal/Sick Days	2% (5-6 days)
Tool Allowance	1% (based on $450 per year)
Escalation	2.5% (assumes $1 pay raise 6 months into the year)
Total	**42.15%**

Example: The labor rate for an employee who is being paid $20 per hour should be about $28.50. At a gross profit of 33%, this employee should be billed to your customer at $42.50 per hour.

Figure 2. Hourly labor rates that include all taxes and benefits are at least 40% higher than an employee's base wage. Your labor invoice to customers should also be marked up to cover overhead and profit.

Cheap Labor

Correcting your markup math won't help you if you don't know what your gross profit should be in the first place. The biggest errors occur when figuring overhead for labor. Contractors hiring employees for the first time often forget to add federal and state employment taxes to the base wage they use in estimates — that costs them about 8% right out of the gate. Forget worker's comp insurance premiums, and it can cost you another 10%, depending on what state you're working in.

Established companies avoid these

elementary mistakes but often miscalculate what it costs to support vacation pay, sick pay, holidays, and other benefits for "nonproductive" time. These costs should be built in to wage rates, but many contractors incorrectly base their calculations on the assumption that their employees work a full day every day all year long. The fact is that full-time employees are productive for between 1,750 and 1,850 hours per year. For another 150 to 250 hours, they're getting paid for tasks you're probably not charging for — truck runs for materials, setting up and breaking down tools and equipment at the start and end of each day, supervising subs, or just standing around trying to figure out what to do next.

One way to ensure that your true labor costs are covered is to calculate the cost of all taxes and benefits for each employee (Figure 2, previous page). Or you can use this shortcut: The rule of thumb is that employees in companies with basic health insurance and vacation benefits cost between 45% and 55% more than what you pay them. If that's not what you're charging for them — plus adding your markup on top — you're losing thousands of dollars for each employee every year.

Poor Job-Cost Accounting

Got the markup thing down cold? You may still be losing money because your estimates are out of date. The culprit is poor job-cost accounting — or maybe none at all. If you never compare an estimate with the actual cost to build the job, then you're flying blind and probably making the same pricing mistakes over and over.

Once again, labor is the biggest problem area, particularly for company owners who no longer bang nails. The longer they've been out of the field, the more they underestimate how long a project will take to build. But even production managers and lead carpenters who are on site all day often omit or underestimate down time — for example, time spent loading, unloading, and moving materials and equipment, or time spent assembling and disassembling staging. They may also underestimate time they themselves spend supervising subs. And almost every estimator forgets the golden rule: Work expands to fill available time. The crew that you estimated would need six hours to complete a task are going to be paid for a full eight-hour day, no matter what.

The solution is to require employees to fill out a time sheet every day, noting not only the number of hours they spend on each job, but also what they were doing. Then, when the job is done, compare labor hours and material invoices to your estimate. If there are big discrepancies, find out why before you make the same mistake in the next estimate. Be sure to check who actually performed the work. Sometimes the actual cost is out of whack with the estimate because a more expensive employee did the work. Keep in mind also that when you're estimating, it's easy to forget that delays create down time and that not all material orders are complete, undamaged, and 100% correct.

Can't Say No

Sound accounting and estimating practices won't save you if you're taking on jobs that you shouldn't be doing. Early on, it may make sense to take every job that comes along. But don't be fooled into thinking that all projects are equally profitable and all customers worth working for.

Nobody is good at everything. By comparing profit figures for different types of jobs — and then comparing job size — you'll begin to see a pattern. Focus on the types of work and the project size that nets you the most profit. Remember, bigger isn't always better — it's the percentage you put in your pocket when it's over that counts.

No Marketing

One reason it's so hard for some contractors to say no is that they have no plan for generating business except to take whatever comes along. In other words, they don't market their services. For companies that started in the 90s, marketing may be a completely foreign concept. After all, the phones started ringing at the end of the 1991 recession, and, in most parts of the country, they haven't stopped ringing yet.

But they will — unless you actively do something to keep customers interested. Don't take your reputation for granted. Even satisfied customers will forget about the wonderful job you did for them if you don't keep in touch with them two or three times each year. It doesn't take much — free maintenance checkups in the spring and fall, a card at the holidays, a phone call after a big storm to ask about damage — but you have to make the effort.

Some business happens by itself, but it's not always the right kind of business. If you know what kind of work is most profitable for you, market to prospects who are most likely to hire you to do it. Begin with past clients, then ask for referrals. It won't hurt to spend a little money on a brochure and postage for a mailing, or a booth at the local home show, or sponsorship of a Little League team. Spending 2% to 3% of total revenues on marketing will pay for itself many times over in new and repeat business.

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