BY MELANIE HODGDON

How *Not* to Discuss Markup With Your Customers

A client of mine, let's call him Jim, recently was put on the spot by a customer for whom Jim had offered a contract price for a sizable project. I should mention that, after my assistance in analyzing his company's historical profitability, Jim has made a commitment to increasing his prices. This job was the first he'd priced since changing his pricing strategy, and he was feeling somewhat insecure about defending the result. Confusing the situation further, the customer had initially worked with a designer who had provided some tentative budget figures. The customer was clinging to those original price suggestions, even though he'd made significant changes to the original plan.

The customer demanded to know Jim's markup. When you're confronted with a similar demand, bear in mind the following as you prepare your response.

COMPARING APPLES AND ORANGES

Markup is irrelevant, because the estimated costs that you "mark up" will vary depending on how you've set up your financials. That means that even if you charge the same price as a competitor, your markup can be vastly different. Let's look at how two different contractors may organize their cost categories (refer to the charts on page 24).

Contractor A has included his labor burdens under Costs of Goods Sold. Therefore, when he estimates what the job will cost, his labor costs will be fully burdened, making the estimated costs high. Because he classifies his production labor burdens in Costs of Goods Sold, his overhead is low.

Contractor B includes only production employee wages in Costs of Goods Sold and includes all burdens in overhead. Therefore, when he estimates what the job will cost, his labor costs are partially burdened, making the estimated costs lower. Because he classifies his production labor burdens as part of overhead, his overhead is higher.

Both contractors charge exactly the same amount for the job, but because of the organization of their costs in their financials, they will apply very different markups to their estimated costs in order to arrive at the same sales figure. In addition, they both are aiming at the same net margin figure (about 8%).

So when uninformed customers compare Contractor A's markup (36.2%) with Contractor B's markup (69.92%), they think it's obvious that Contractor B is charging much more, even though the sales figures are the same. And this is exactly why bandying about markup figures when talking with customers is pointless.

> "Markup is irrelevant, because the estimated costs that you 'mark up' will vary depending on how you've set up your financials."

The better question to ask your customers is whether or not they feel that a net profit of 8% (or 10%, or whatever your target net is) as a reward for the risk of being in business to produce and support a quality result for them is reasonable. Their answer may also be used as a qualifier: If they balk at that, that's an excellent signal that you should walk away.

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Contractor A	
Job Sales Price	$130,000.00
Labor Costs	
Wages	$25,000
Payroll Taxes	$4,625
Workers' Comp	$3,750
Liability Insurance	$550
Paid Time Off	$1,500
Health Insurance	$4,500
Retirement	$750
Vehicle Costs	$2,500
Communication Costs	$900
Material Costs	$20,000
Sub Costs	$30,000
Other Direct Costs	$1,500
Total Estimated Costs	**$95,575**
Gross Profit	$34,425
Gross Margin	26.48%
Markup	**36.02%**
Overhead Costs	$24,000
Total Overhead	$24,000
Net Profit	$10,425
Net Margin	8.02%

Contractor B	
Job Sales Price	$130,000.00
Labor Costs	
Wages	$25,000
Material Costs	$20,000
Sub Costs	$30,000
Other Direct Costs	$1,500
Total Estimated Costs	**$76,500**
Gross Profit	$53,500
Gross Margin	41.15%
Markup	**69.93%**
Overhead Costs	$24,000
Payroll Taxes	$4,625
Workers' Comp	$3,750
Liability Insurance	$550
Paid Time Off	$1,500
Health Insurance	$4,500
Retirement	$750
Vehicle Costs	$2,500
Communication Costs	$900
Total Overhead	$43,075
Net Profit	$10,425
Net Margin	8.02%

How you mark up for labor, subcontractors, and materials is not the point a customer should be obsessing over, as these examples show. Contractor A has included his labor burdens in Costs of Goods Sold, so his estimate reflects labor costs that are fully burdened, making the estimated costs high. Because he classifies his production labor burdens in Cost of Goods Sold, his overhead is low. Contractor B, on the other hand, includes only production employee wages in Costs of Goods Sold, and includes all burdens in overhead. Therefore, when he estimates what the job will cost, his labor costs are only partially burdened, making the estimated costs lower. But because he classifies his production labor burdens as part of overhead, his overhead is higher.