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Understanding labor pricing, Part 2

BY JOHN ZINK

When a new contracting company starts up, how does the business owner know what to charge for its work? The simple answer is *"Enough to cover all expenses and earn a profit."*

Last month (*pg. 69*) we examined how business owner Tom calculated his company's labor expenses. By dividing his labor costs of $208,000 by the 5,408 hours of billable hours that his techs can work in a year, Tom determined that he needs to charge his customers $38.46 per hour just to pay for his technicians and nothing else. Next he has to account for his salary and all the other company expenses that fall into the overhead category.

Fixed and variable overhead

The two categories of overhead are fixed and variable. In simple terms, fixed overhead refers to the expenses Tom would have even if he did no work (rent, utilities, dues) and variable overhead refers to the expenses that rise and fall depending on his volume of work (labor costs, vehicle expenses, tool replacement). Tom does some planning and comes up with an overhead worksheet that includes all the costs he can think of.

Tom made a couple assumptions and missed a few items in his worksheet, but he has a good start. As other costs become apparent, he will add them to this sheet and make adjustments accordingly. Tom adds his variable and fixed overhead costs to determine that he has $22,325 in monthly overhead expenses. He multiplies this by 12 to determine that his annual overhead cost is $267,900.

Tom now has the information he needs to determine his company's true cost of doing business, otherwise known as the break-even point. He adds his $208,000 in annual labor costs to his $267,900 in annual overhead and then divides that number by his techs' 5,408 billable hours. This calculation tells him that he needs to charge his customers $88 per hour just to break even and pay for the everyday costs of running the company.

Calculating profit

Tom wants his company to do better than just break even! He feels a responsibility to his employees and his customers to build some retained earnings. These earnings help companies survive unexpected downturns or expand as needed. Tom forms his profit goal with these factors in mind, along with the knowledge that taxes will take a portion of earnings away. Tom settles on a 20% pre-tax profit target for his company.

To calculate what to charge for profit per hour, Tom uses this formula:

Profit per hour in dollars = 20% divided by (1 - 20%) multiplied by $88

This calculation gives him $22 to charge for profit per hour. Tom adds this to his $88 break-even rate for a total of $110 per hour. He also could have just divided his $88 break-even rate by .8 (80%) for a total of $110.

At this point, Tom has to take a moment to collect his courage. He knows of companies in the area charging $40 an hour. After reviewing his numbers again, he knows that if he wants to pay his real costs, pay his technicians and pay himself what he wants to earn, he must settle for nothing less than what the real numbers on his worksheets have told him.

Tom soon learns that when clients are happy with his professional, high-quality work and great customer service, few are concerned with the hourly rate. Tom eventually also finds other ways to manage his hourly charges, including applying profit against material mark-ups and flat-rate pricing systems.

Understanding labor costs, overhead and proper pricing are crucial pieces in the puzzle of creating a successful company, especially for new business owners. The exercises above are simply a starting point and just one part of a more complete overhead education tool that will be available from the PHCC Educational Foundation in 2007.

Overhead worksheet

Fixed Overhead Item	Monthly Expenses		Variable Overhead Items	Monthly Expenses
Owners Salary ($75k/yr.) + 30% Benefits, Insurance & Taxes	$8,125		Bad Debt	$500
Office Manager Salary ($30k/yr.) + 30% Benefits, Taxes, Insurance	$3,250		Cell Phones	$200
Advertising/Marketing	$400		Credit Card Charges/Fees	$50
Contributions & PHCC Dues	$300		Tech Education & Training	$200
Insurance (General, Liability, etc.)	$1,800		Equip. & Tool Replacement	$300
Interest (Loans)	$200		Insurance (Vehicle)	$800
Legal & Accounting Fees	$350		Vehicle Payments, Licenses	$1,600
Staff Education & Training	$250		Vehicle Fuel and Repairs	$2,000
Office Supplies & Equipment Rental	$400			
Office Rent + Utilities	$1,600			
Subtotal Fixed Overhead	**$16,675**		**Subtotal Variable Overhead**	**$ 5,650**

Note: Please keep in mind that the values listed are for example purposes only. You will need to determine your own costs for these line items and any others that you wish to include in your calculations.

If you would like to practice calculating overhead and pricing with some sample worksheets, please visit the Foundation's Contractor Resource Center at *http://www.foundation.phccweb.org*. From there, you can download Excel spreadsheets and plug in different numbers to see their effect on a sample company.

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