

OVERHEAD: Recovering the Obvious

There Are Numerous Methods For Calculating Overhead, And Here Is a System Based on Setting It as a Function of Labor

By Irv Chasen



(The author, Irv Chasen, of this article on overhead and operating cost recovery is a former contractor and now head of the firm PROOF-Profit Research on Operating Factors.)

The "PROOF" Program has long stressed the importance of recovering overhead and operating cost as a function of labor. Some contractors find this principle difficult to accept. However, there are many advantages to relating to overhead as a function of labor.

Many contractors do not have an accurate system for relating to overhead cost at all. The ones that do normally relate to overhead as a relation to labor and material combined or volume. Other large contractors are not interested in a "labor only" system and prefer a

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**TABLE A
OVERHEAD STRUCTURE BASED ON LABOR AND MATERIAL**

Approximate Time and Number of Men	Job #1 4 Men/1 Year	Job #2 4 Men/3 Months	Job #3 5 Men/6 Months
Material	\$10,000	\$40,000	\$25,000
Labor	40,000	10,000	25,000
Subtotal	50,000	50,000	50,000
Overhead 25% on Labor & Materials	12,500	12,500	12,500
Subtotal	62,500	62,500	62,500
Profit 5% on Cost	3,125	3,125	3,125
Selling Price	\$65,625	\$65,625	\$65,625

**TABLE B
OVERHEAD STRUCTURE BASED ON LABOR ONLY**

Approximate Time and Number of Men	Job #1 4 Men/1 Year	Job #2 4 Men/3 Months	Job #3 5 Men/6 Months
Material	\$10,000	\$40,000	\$25,000
Labor	40,000	10,000	25,000
Subtotal	50,000	50,000	50,000
Overhead 50% on Labor	20,000	5,000	12,500
Subtotal	70,000	55,000	62,500
Profit 5% on Cost	3,500	2,750	3,125
Selling Price	\$73,500	57,750	\$65,625

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“sliding” or “dual” overhead system. For a moment we would like you, the reader, to put aside all other preferred systems so we can scientifically review some of the advantages of overhead recovery as a function of labor.

Below are last year’s operating costs for Acme Contracting Company (fictitious company). We will use these statistics to manage Acme’s business for the upcoming year.

Labor Cost	\$200,000	20 men
Material Cost	200,000	
Overhead Cost	100,000	
Profits	25,000	
Total Volume	\$525,000	

Let’s take a look at three fundamental ways of relating to Acme’s \$100,000 overhead cost:

- (1) Overhead equals 50% of Labor Cost (\$100,000 divided by \$200,000).
- (2) Overhead equals 25% of Labor and Material Cost (\$100,000 divided by \$400,000).
- (3) Overhead equals 19% of Volume (\$100,000 divided by \$525,000).*

The \$200,000 payroll was generated by 20 men, so each man generated an average of \$1,250.00 profitability (\$25,000 divided by 20).

In *Table A*, we will show how Acme decided to bid three jobs using an overhead structure based on Labor and Material (Item #2 preceding).

Note that all three jobs have the same total labor and material cost and the bid for each job is the same \$65,625. However, as you can see, the ratio of labor to material varies considerably for each. Note further that indirect or overhead cost is the same for each job.

Acme surveys the situation and

*Some contractors might bid this job on a volume overhead structure, figuring their overhead at 19% of volume. They might multiple the labor and material cost by 19%, assuming this would recover the necessary overhead cost, but unfortunately this will not work. The 19% is based on selling price and **not** cost of labor and materials.

decides the indirect or overhead cost to operate all three jobs cannot possibly be the same.

Job #1 is a difficult job with a slow rate of production. It will last one year and could employ 4 men—one-fifth of Acme’s crew for the year.

Job #2 is a simple job with a high rate of production outlook. It will take three months with the same 4 men—one-fifth of Acme’s force for three months.

Job #3 is fairly typical of jobs encountered by Acme—not too quick and not too slow.

Now, let’s take a look at *Table B* shows the same three jobs, only this time relating to overhead as a function of labor *only* (Item #1 preceding).

From a cost standpoint, the overhead on labor only aspect appeals to Acme. Now, he is super-competitive on the high material/low labor job (*Job #2, Table B*) which was the job he was most interested in obtaining. On the equal labor and material job (*Job #3, Table B*), the price was the same as in *Table A*. But on the high labor/low material job (*Job #1, Table B*), Acme is not as competitive. However, Job #1 was the troublesome job anyway and Acme wants to explore this bid strategy a little further.

Normally, Acme operates a crew of approximately 20 men. Furthermore, they have the supervision, equipment, dependable manpower and other facilities to operate efficiently at the 20-man level.

With this 20-man desired capacity, Acme could perform only 5 high labor/low material jobs such as Job #1 in *Table B* (\$40,000 labor x 5 jobs = \$200,000 yearly payroll). If they received profits of \$3,500 per job (5% of cost, Job #1, *Table B*), then the total yearly profitability would amount to \$17,500 (\$3,500 x 5 jobs) or \$875.00 average per man (\$17,500 divided by 20 men).

On the other hand, Acme could perform 20 jobs such as Job #2, *Table B*, with the 20-man crew (\$10,000 payroll per job x 20 jobs

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= \$200,000 yearly payroll). If they received \$2,750.00 profits (5% on cost) per job (*Job #2, Table B*) for each of these jobs, then the yearly profitability would amount to \$55,000 (20 x \$2,750) or \$2,750 average profitability per man. If competition bids this job relating to labor and material (as in *Table A, Job #2, \$65,625*), then Acme could conceivably increase this 5% margin and still be well below the \$65,625.

Now obviously, a contractor can't operate in a "test tube" environment such as the situation portrayed here. However, recovering overhead as a function of labor should be given serious consideration. In the case of *Job #2, Table B*, Acme would be in the most competitive situation on that job when relating overhead to labor only. Remember that *Job #2* would be the quickest and easiest job to perform.

There are other reasons for relating overhead to labor only:

(1) All jobs have labor and labor is the best measurement of time. It is this lapse of time which generates most overhead cost. Furthermore, it is labor itself that creates a large portion of overhead cost.

(2) The degree of completion of any job can best be measured by the amount of labor already expended as compared with the amount yet to be expended. If we attempted to measure the degree of completion by materials delivered to or on hand for a particular job, we would see a rather distorted picture. For example, if 100% of the materials had been delivered to the job site, that in itself would not be any measure of degree of completion. In short, since labor obviously is the best measure of job progress, why not use this same barometer to monitor percentage of overhead cost expended?

There are many sound methods of managing a contracting company and recovering overhead cost. We know that as a contractor you must, in many cases, bid jobs for

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each consultant being considered for the contact. Though one problem may have great similarity to another there are usually important minor considerations that form part of the problem and these have an important role in selecting that expert. The depth thereof gives insight into each individual's background and understanding of the specific problem, its scope and its goals.

Be sure that there is total understanding of the problem as part of the contract signed with the expert. Take nothing for granted. Never assume that certain points are covered as a matter of routine. And get it in writing.

Make certain that the contract describes what the consultant expert will deliver as a result of his work and that this covers what is expected from this efforts. The more specific details are involved the better solution will be forthcoming and the greater depth of investigation will be made into each possible aspect of the problem under consideration.

Cost of the consultants services is, of course, of top importance but he should be selected on a basis of what he can deliver rather than upon the amount of the fee alone. Bargain price business consultants and experts often provide meager results.

Set a specific date for completion of the project with penalties presented in detail for failure to comply with this time. Doing so assures concentration of the experts efforts on the project in greater detail than if no time limits are involved and he is therefore free to take off in a half dozen other directions in the meantime.

Assign a specific individual on your staff to serve as a contact with the expert; everything will go smoother when that step is taken.

Finally, convince yourself that his fees are a good investment or don't go into the deal in the first place. Otherwise, it may turn out to be an unhappy and perhaps a profitless arrangement. □

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"what the traffic will bear." But profitability shouldn't be measured by numbers of men alone. Remember, Acme could produce \$875.00 profitability per man with its 20-man crew working high labor/low material jobs as in *Job #1, Table B*. Yet, this same 20-man crew could possibly generate \$2,750 profitability per man while working high material/low labor jobs such as *Job #2, Table B*. In other words, a contractor may turn a quicker buck on material than on labor.

Of course, it would be ideal if a contractor could obtain all the available work he desired. But, let's face it, this isn't going to happen. So, why not combine your estimating and bid strategy skills and try to procure the jobs that will assure proper recovery of all overhead cost and give you the quickest profits? The retailer is interested in high turnover because he knows it can result in more volume and thus more profitability. Why shouldn't contractors consider the same principle? □