

ACHIEVING BUSINESS FINANCIAL GOALS AN ACTION PLAN FOR LEVERAGING PRICING MULTIPLIERS FOR CONTRACTORS AND MANUFACTURERS

Understanding pricing multipliers and having the ability to use them effectively and track their results properly makes a tremendous impact on bottom line profits. The information in this action plan includes detailed explanations of the pricing multipliers and a simple system for leveraging them to achieve budgeted profit goals.

First, we will define pricing multipliers and review the profit goal standards that they create.

Second, we will look at a system that, if used on a day-to-day basis in conjunction with the pricing multipliers, will help accurately control profits.

Third, we will provide an approach to using the pricing multipliers as a competitive bidding advantage.

DEFINING PRICING MULTIPLIERS

What Is a Pricing Multiplier?

A pricing multiplier is the factor used to calculate the pricing standard for a business that will achieve its budgeted profit goal. This action plan provides pricing multipliers that are unique to each business for its major direct cost categories: Labor and MESO. (The MESO category is the sum total of the Material, Equipment, Subcontractor, and Other direct costs.) These pricing multipliers have been calculated through a series of complex calculations applying the “dual overhead burden” method, blending prior year performance with anticipated annual cost increases and/or decreases along with the profit goals for the budgeted year. The “dual overhead burden” method is one of the most accurate pricing methods available because it allocates the amount of budgeted burden to both the labor and MESO categories proportionate to the business’s historical performance.

How To Use the Pricing Multipliers.

To calculate the budgeted sales price for each job or product, the LABOR or MESO pricing multiplier is multiplied times the estimated cost of each of these major direct cost categories. The calculated prices for the major cost categories are then summed to determine the total sales budget for each job or product. If a business could sell every job or project at this calculated price, it would achieve its budgeted profit goal for the year (assuming that the rest of the other budgeted line items are managed to budget). Of course, competition comes into play when pricing jobs or products, and a business may be able to charge more for some work; or, may have to charge less to capture other work. The systems that are discussed below can help manage the variances in pricing due to the realities of the competitive environment.

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Labor-Only Pricing Multipliers.

This action plan also contains a different pricing multiplier for applying burden and profit to labor only. We don't recommend this method because the dual overhead approach is more effective. Nevertheless, if it is decided to use only labor to cover burden and profit, this labor-only multiplier would be multiplied times the estimated direct labor costs to determine the budgeted selling price for labor; then, the estimated MESO costs would be added to this number for the final budgeted selling price. The same system recommended below for managing variance throughout the course of the year would be used.

Breakeven Multipliers.

"Breakeven" pricing multipliers are also provided in this action plan that, when applied to the direct cost categories, will calculate a "walk-away" price. The resulting price using these multipliers is that price at which a business is covering its costs only (including burden but not including profit). If a job or product is priced below this breakeven number, a loss would be incurred for that job or product.

The result of using specific and accurate job/product pricing multipliers is that they will create an accurate pricing standard from which to manage and track profit goals. These standards can then be systemized to form an easy way to track performance to budget. Later in this action plan we will discuss how to manage this information in context of actual market conditions and describe a system that will help facilitate tracking company performance.

CALCULATING PRICING STANDARDS WITH MULTIPLIERS

The income statement has been formatted to allow only 5 specific items to be included in the "Direct Cost" line items: Labor, Material, Equipment, Subcontractor and Other. The Material, Equipment, Subcontractor and Other direct costs are aggregated into a major direct cost category called MESO. These are the only direct costs items that should be used to estimate a job or product's cost because they are easily estimated and/or determined, and there is no need to include other line item costs that are difficult to estimate on a per job or product basis. Examples of non-direct line item costs are corresponding payroll taxes, union costs, etc.

Since the "dual overhead burden" method applies the entire burden ONLY to those items that are listed as job or product expenses in the "direct cost" line items, care must be taken to properly allocate the actual direct labor costs and the direct "MESO" costs.

If jobs or products are priced using both direct labor and materials (MESO):

- 1) Labor cost allocation: As an example, if an employee has both non-field/production duties in the field or during production, the proportionate share of each should be allocated to direct cost labor and fixed cost administrative salaries as appropriate.

- 2) Material, equipment, subcontractor and other allocations: ONLY the actual materials, equipment, subcontractor or other expenses that are actually used for the job should be included in the direct cost MESO line items.

If jobs or products are priced using direct labor, materials (MESO) and/or equipment/machine time:

- 1) Equipment or machinery cost allocations: To properly apply burden to specific equipment or machinery, the actual cost of the equipment or machinery MUST be included in the direct cost line items. These costs would include such things as maintenance and repairs, the fuel or electricity to run the equipment or machinery and the straight line depreciation for each piece of equipment or machinery whose time will be part of the estimating process.
 - (a) It is recommended that the direct cost line item entitled: "Direct Cost - Equipment" be used to contain all the costs for all of the maintenance and repairs and the fuel/electricity pertaining to the equipment/machinery that will be broken out and estimated for customer specific jobs.
 - (b) The line item entitled: "Direct Cost – Subcontractor" will be used as usual for those subcontractor costs that pertain only to customer jobs.
 - (c) It is recommended that the direct cost line item entitled: "Direct Cost – Other" be used to contain the depreciation specific to the equipment/machinery that will be estimated for the job. Any accelerated depreciation that was applied to the equipment/machine and all other depreciation would be listed in the fixed cost category of expenses on the standard "depreciation" line item. (For financial management purposes, remember to add the two depreciation line items together to determine the total depreciation for all company equipment/machines.) If the actual costs and hours of usage of each piece of equipment or machine have been properly tracked, its actual cost per hour can be determined. To estimate the MESO category, during the estimating or bidding process, the cost of materials must be estimated and the number of hours each piece of equipment or machinery will be used must be estimated times the cost per hour. The total materials, equipment or machine cost, subcontractor and other costs will be added together for a total cost of MESO. (To determine the hourly selling price of a piece of equipment or machinery, multiply its hourly cost times the MESO multiplier for the final hourly selling price.)

NOTE: The sample calculations below show equipment/machine time priced as a separate line item. If equipment and/or machine time are not tracked as direct costs and/or if they are not priced separately in the pricing process, this line item would not be included in pricing calculations. However, the logic of using pricing multipliers and tracking variances remains the same.

Sample Calculations

Estimate the actual labor and MESO cost for a job.

Labor Cost Estimate: 150 hrs X \$24.50/hr (w/o benefits)	\$ 3,675.00
MESO Cost Estimate	\$ 740.00
Equip/Mach time: 150 hours @ \$115.20/hr	\$17,280.00

Sales Price Calculation:

Labor: \$3,675 X 2.5028 Labor multiplier	\$ 9,197.79
MESO: \$740 X 1.6271 MESO multiplier	\$ 1,204.05
Equip/Mach time: \$17,280 X 1.6271 MESO	\$28,116.29
Budgeted Sales Price	<u>\$38,518.13</u>

Tracking the Variance:

Job 1: Budgeted Sales Price (as calculated)	\$38,518.13
Market Sales Price (as determined by sales dept.)	\$39,500.00
Variance:	OVER BUDGET <u>\$ 981.87</u>

Job 2: Budgeted Sales Price (as calculated)	\$ 20,145.00
Market Sales Price (as determined by sales dept.)	\$ 19,700.00
Variance:	UNDER BUDGET <u>\$ (445.00)</u>

Net Performance to Budget for Above Jobs

Variance: \$981.87 - \$445.00	OVER BUDGET	<u>\$ 536.87</u>
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The sales department, not the accounting department, should have the flexibility to determine the final sales price within management's criteria, and the final sales price should be compared to the budgeted selling price. Then, the variance should be tracked and recorded. When selling a job or product for a price less than the standard, the amount of discount to "get back" to the budgeted pricing standard is clearly known. Remember, the budgeted pricing standard is based upon the prior year's history where some jobs/products were probably sold at a discount and others for a premium. At the end of any period of time, week, month, year, if the variance is equal to or larger than "0", the budgeted profit has been achieved or exceeded. Keep in mind that if big jobs or orders are discounted that are processed over a period of time, the total amount of discount that must be recaptured will not necessarily be all within a one month period. If a job is discounted that will run say 10 months, that discount will have to be "recaptured" over jobs within the next 10 months.

The breakeven multipliers should be used in the same way as shown above to establish the minimum acceptable price standard. This is the "walk away" price. The

variance between any final price and the budgeted selling price standard should always be tracked carefully.

USING THE RELATIONSHIP BETWEEN DUAL OVERHEAD RATE MULTIPLIERS AND A SINGLE OVERHEAD RATE AS A COMPETITIVE ADVANTAGE

The relationship between the dual overhead rate multipliers and the single overhead burden rate multiplier can be used for a bidding advantage. Here's how. The dual overhead rate multipliers are calculated using the average ratio of the direct labor cost to the average direct MESO costs. The burden and profit are then proportionally allocated between the company's historical ratio of direct labor to direct MESO. Let's call this the "sweet spot" of the company's historically average job or project. On the other hand, the single overhead rate multiplier is calculated by simply applying all of the burden and profit to direct labor only.

First, the budgeted sales price of a job or project needs to be calculated by using the dual overhead rate multipliers as shown in the examples above using the estimate of labor and materials. Next, calculate the budgeted selling price using the single overhead multiplier that uses labor costs only plus the cost of materials.

Now, compare the two budgeted sales prices. The base standard will be the budgeted selling price calculated from the dual overhead multipliers. Let's assume that it is known that the competition almost always applies all of their burden and profit to direct labor. If the price using the single overhead rate multiplier is higher than the price calculated using the dual overhead multipliers, the chances are the budgeted price will be lower than the competition because the competition probably has more labor than the company's "sweet spot" job. Knowing this, the price could be increased slightly so as not to "leave anything on the table". Conversely, if the price using the single overhead rate multiplier is lower than the price calculated using the dual overhead multipliers, the chances are the budgeted selling price will be higher on the bid because the job probably has less labor in it than the company's "sweet spot" job. To get the job, it will probably have to be discounted. If the two prices are very similar, the job to be bid is almost identical to the company's "sweet spot" job and the budgeted price will be very competitive. Remember, all variances from the pricing standard need to be tracked as explained above.

SYSTEMS FOR CONTROLLING PROFITS USING PRICING MULTIPLIERS

The result of using specific and accurate job pricing multipliers is that they will create an accurate standard from which to manage to achieve profit goals. These standards can then be systemized to form an easy way to track performance to budget.

An example of systems that can be used to manage profit goals can be found below.

- 1) Job /Product Cost and Pricing Worksheet – This form is used, or customized if necessary, to provide a template for proper job, product or service pricing.
- 2) Job/Product Cost and Pricing Budget Worksheet – This form is used, or customized if necessary, to track the variance of the budgeted selling price from the actual selling price. If a job, product or service has been discounted

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or marked-up from the budget price standard on a job or project that will be performed over many months, track the proportionate amount of variance each period so you know what amount of variance must be recaptured or can be used to discount future sales without sacrificing the budget goals.

[SEE SAMPLE FORMS ON NEXT TWO PAGES]

Sample from: www.TheProfitForecaster.com

JOB COST WORKSHEET

Project Manager: _____

Date: _____

Customer Name: _____

Customer P. O. #: _____ Customer Chg Ord. #: _____

Job Name: _____

Co. Job #: _____ Co. Change Order #: _____

Job Pricing Approval: Mgr. _____ CFO _____
Date: _____ Date: _____

Type of Job: _____ Bid _____ Wage Reporting: _____ Yes _____ No _____
T&M

Line No.	Description	Cost Breakdown	Sales Price Total(s)
1	Labor Cost: Rate _____ Hrs. _____		
2	Labor Multiplier	X _____	
3	LABOR BUDGET SELLING PRICE (#1 X #2)		
	MESO Calculations:		
4	Material (add freight and sales tax)	_____	
5	Equipment (add freight and sales tax)	_____	
6	Subcontractor(s)	_____	
7	Other (permits, company and/or equipment rental, travel, etc.)	_____	
8	Subtotal MESO Cost:	_____	
9	MESO Multiplier	X _____	
10	MESO BUDGET SELLING PRICE (#8 X #9)		
11	LABOR + MESO BUDGET SELLING PRICE (#3 + #10)		
12	Bond Multiplier (If bonded by Co.)		X _____
13	Bond Cost (#11 X #12)	_____	
14	MESO Multiplier (#9)		X _____
15	BOND BUDGET SELLING PRICE (#13 X #14)		
16	MESO Cost (Subtotal MESO Cost + Bond Cost) (#8 + #13)		
17	Total Costs of Sales (#1 + #16)		
18	BUDGET SALES PRICE (#3 + #10 + #15)		
SALES TAX AND OPTIONAL MARKETING CALCULATION			
19	Market Price Increase (Decrease) (If necessary, adjust for competition or customer)		_____
20	Extraordinary Travel or Freight (if not included in #7 above)		_____
21	Sales Tax (on #18 above - if applicable)		_____
22	TOTAL MARKET SALES PRICE (#18 + #19 + #20 + #21)		

