

# THE AUTOMATED MILLIONAIRE BEST BUSINESS PRACTICES OVERHEAD ABSORPTION FACTOR



By  
Mikkel Pitzner



## **BEST BUSINESS PRACTICES**

# **Overhead Absorption Factor**

Mikkel Pitzner  
The Automated Millionaire  
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## **BEST BUSINESS PRACTICES**

The Automated Millionaire Best Business Practices describes various Best Business Practices and/or Terminology used in business. These are aimed at giving you a better insight to terminologies, explanations or 'How Tos' for your business.

### **A NOTE ABOUT LINKS IN THIS DOCUMENT**

Throughout this document you will find links (such as the yellow link just below) for more resources, which could be training videos, other documents or access to tools and the like. The individual links are directed to specific sections and resources relevant to what is being said it's linked to, but for your privacy and security, all links are sent to pages residing secured website of The Automated Millionaire website.

**[Click Here For More  
Resources](#)**



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## To Your Success

*I truly wish your success.*

*I believe entrepreneurs are critical for our society and that it is the entrepreneurs who often pave the way for innovations and development in the world.*

*Entrepreneurs accept great risk, work diligently and often have to endure great struggles in their pursuit of their dreams.*

*Those who succeed not only improve their own lives, but also many other lives. Lives of the other people in their families, but also lives of the people they employ and their families. Vendors as well and their families are positively affected by the ripples sent out from a well run and successful business.*

*I am therefore hopeful that my personal pursuit of helping as many entrepreneurs as possible can help increase these positive ripples, affecting as many people positively and as far reaching as possible.*

*Please feel free to connect with me for anything you believe I may be able to help and serve you with.*

- Mikkel Pitzner

Email [Mikkel](#)



## Overhead Absorption Rate

Overhead Absorption is defined as the allotment of overhead to cost units. The purpose of determining an overhead absorption factor is to establish a rate relevant to your business that can be applied to your pricing, so you ensure you recover all your non-direct costs into the price of your products or services.

It's simply a method of absorbing or including an appropriate amount of overhead costs into your pricing of what you're selling.

From our Best Business Practice on Gross Profit and Gross Profit Margin we spoke a bit on the topic of Variable or Direct Costs which goes into your Cost of Goods Sold. We also there saw how we account for those expenses when price our products or services.

From our Best Business Practice supplements on Markup Vs. Margin as well as the one on Labor Burden, we also saw how we could account for all Labor Burden (all costs associated with labor including those that would not be covered by the Cost of Goods items, as well as ensuring we account for what will be part of our profits at the end of the day.

But to ensure that we truly do end up with profits we do have to ensure, that we first cover ALL our costs, and to that end we still need to ensure that we cover our costs for non-direct or fixed expenses that we haven't already covered via e.g. the Labor Burden.

That's where the Overhead Absorption Rate comes in.

The following will show one method we can use to accomplish this task.



In business we have the term called Cost of Goods Sold as I also mention above. We have written about this in our Best Business Practice on the topic a of Gross Profit and Gross Profit Margin, as well as in the Best Business Practice on Markup Vs. Margin.

Cost of Goods Sold are the expenses that should be included into any estimate, quote or price setting. These expenses are directly related to producing or delivering upon what we are selling. These expenses are also said to vary with the level of output that we produce.

Fixed Costs, also often called Overheads, are all the expenses that are not included in the estimated Cost of Goods Sold. These costs are sometimes additionally referred to as Non-Direct costs, or General & Administrative costs or Indirect Costs.

The Overhead Factor or Overhead Absorption Rate is defined as the relationship between the Fixed Costs (Non-Direct Costs) and the total Cost of Goods Sold.

$$\text{Overhead Factor} = \frac{\text{Fixed Costs}}{\text{Cost of Goods Sold}}$$

Basically, what we are doing here is to say that for every dollar that we spend on Cost of Goods Sold, we need to spend an addition \$x to cover our Fixed Costs. We are in essence spreading our fixed costs over the level of Cost of Goods Sold.

We can calculate the Overhead Absorption Rate based upon historical financial data (e.g. our results from last year) or on projected financial data (your budget). By definition our Fixed Costs do not vary with the level of output, however our level of Cost of Goods Sold do vary with the level of output. Therefore the latter will have an effect on the Overhead Absorption Rate and therefore, we should continually monitor our Overhead Absorption Rate.

In effect this means that our Overhead Absorption Rate is never fixed or constant, but it continually moving and changing.



Let's look at an example: Say we have a company with the following results:

Revenue	\$ 957,444
Cost of Good Sold	\$ 687,567
Fixed Expenses	\$ 217,565
Profit	\$ 52,312

In this case we would divide our Fixed Expenses of \$217,565 by our Cost of Goods Sold \$687,567, which would result in 0.3164 or expressed as a percentage in 31.64%, thus giving us an Overhead Absorption Rate of 31.64%.

This calculation though does not take into account expenses that are “off” our Profit & Loss Statement, but that live on our Balance Sheet. I'm referring specifically to expenses such as repayments of debt principals (remember that out of your debt servicing you pay interest payments via your Profit & Loss Statements, but your Principal repayments are only shown on your Balance Sheet).

In order to take account of the payments also, we need to add the principal repayments to our Fixed Expenses, so

Let's say we have 87,400 in principal repayments, our adjusted Overhead Absorption Rate becomes:

Fixed Costs (\$217,565) + Principal Repayments (\$87,400) Divided by our Cost of Goods Sold (\$687,567) = 0.4435 or a rate of 44.35%

So in quoting we would need to take this Overhead Absorption Rate into account too.

Let's imagine you have a production facility and that you are quoting a specific job.





Let's say you have total cost of materials for that job of \$3,580 and that you'll need 287 labor hours to complete it, and that your hourly rate is \$22 for your labor plus a labor burden of 44.5%

Your price calculation would then look like this:

Materials		\$ 3,580
Labor	\$22 x 287 hours	\$ 6,314
Labor Burden	\$6,314 x 44.5%	\$ 2,810
Total Cost of Goods Sold		\$ 12,704

Now we want to apply our Overhead Absorption Rate, which would be our rate of 44.35% x Total Cost of Goods Sold:

Total Cost of Goods Sold		\$ 12,704
Overhead Absorption Rate (44.35%)		\$ 5,634.10
Subtotal		\$ 18,338

This gives you the Break Even Point for doing this specific job.

Let's say you have a desired Profit Margin of 35%, then your calculation would look as follows:

$$\text{\$18,338} / (100-35)\% = \text{\$28,212.31}$$

For some jobs you may have a contingency factor or a weather factor (as in construction industries) added to your quote, let's say that was 5%, which would mean you would just add 5% to your price:

$$\text{\$28,212.31} \times 1.05 = \text{\$29,622.92}$$



This amount represents your total selling price needed to maintain the desired profit margin. Comparing this to your current price indicates if your selling price is adequate

The overhead rate or the overhead percentage is the amount your business spends on making a product or providing services to its customers. To calculate the overhead rate, divide the indirect costs by the direct costs and multiply by 100.

If your overhead rate is 20%, it means the business spends 20% of its revenue on producing a good or providing services. A lower overhead rate indicates efficiency and more profits.

*“Obviously the better you can manage your costs, the better you will be able to actually apply all the right math to ensure that your business ends up making the desired profit. But as your costs rise, and you start adding on all these factors, your selling price quickly becomes very large and possibly so large that you now are no longer competitive in your marketplace.*

*Helping our clients we typically make changes in the efficiencies of the clients’ businesses, so that by being more efficient the costs of producing what they are selling goes down. Efficiency improvements can often really move the needle a lot even with what can seem like small efficiency improvements.*

*Using a specific method and system helps to bring forth these improvements and helps the implementation of results improving changes.*



*This is largely what I teach in my programs. I stress the importance of business owners getting a true understanding of how these dynamics work, so they can get a better grip on their business, and then help them and their teams implement an easy to follow 8 simple step business system that has proven to be repeatable, effective and successful.*

*By the short time the business owner and his/her team has gone through the program, they are now equipped to continue the path on their own and are now capable of creating the desired results knowing what to do in order to get there and in order to secure their success.”*

- Mikkel Pitzner

*“It’s incredibly important to really know your costs.*

*That means also getting to understand some of these calculation methods for getting to grips with your true cost of labor as in this case in this Best Business Practices.*

*However, it doesn’t always mean that we can just then add our markup as we desire and get away with it in the marketplace, as we may in the process out price ourselves against competition.*

*But at least you need to know where you are.*

*Then after that you can make decisions of more strategic character if needs be and when that serves a great purpose.*

*But without knowing these matters well, you are just making uneducated decisions, and that is very dangerous, when you run your business.*



*Again, running a business truly well for profits, is to large extend a matter of attaining the right knowledge and insights as to how to do so, and implementing sound and efficient systems.*

*But as you can see, it is remarkable improvements that can be made by positively affecting your business in one or several areas.*

*Colleagues and myself have successfully implemented a system in many companies helping to turn their results from struggling positions to truly successful companies or helping successful companies perform even greater.”*

- Mikkel Pitzner

*If you wish to see how this system works, so you can implement this in your business, then simply click the link below:*

**How To Turn Around Any  
Business In 8 Simple Steps**



## Key Takeaways

- It is necessary to charge each unit of production with its share of overhead expenses to ascertain the total cost of each unit (unit being job, unit of product, unit of service).
- The charge made to each job, order, process, unit or product to recover indirect cost is known as absorption of overhead.
- Absorption actually means the distribution of the overhead expenses allotted to a particular department over the units produced in that department.
- Overhead absorption is accomplished by overhead rates.
- In the above method we accomplished this by finding our Overhead Absorption Rate by taking all of Fixed Expenses and divided this by our Cost of Good Sold. Effectively we are “spreading” our fixed costs over our Cost of Goods Sold.
- There are other ways of calculating your Overhead Absorption Rate, including this one: A basic procedure for the calculation of overhead rate is to divide the amount of overhead expenses by the total number of units of the base selected as units of products, direct labor hours, machine hours etc.
- In latter example this means:  $\text{Overhead Rate} = \frac{\text{Overhead expenses}}{\text{Total quantum of basis (quantity or value)}}$ .



- **Compare To Sales:**

Sometimes used, when setting prices and making budgets. To calculate the proportion of overhead costs compared to sales, divide the overhead cost by the sales, and multiply by 100.

For example, a business has sales of \$1,000,000 and overhead costs totaling \$400,000, which equates to  $(\$400,000 / (\$1,000,000 \times 100)) = 40\%$  overheads.

- **Compare to Labor**

To measure the efficiency with which business resources are being utilized, calculate overhead cost as a percentage of labor cost. The lower the percentage, the more effectively your business is utilizing its resources.

Divide the total overhead cost by the total labor cost for the month and multiply by 100 to express it as a percentage.

Direct Labor Percentage =  $\text{Overhead} / \text{Direct Wages} \times 100$

- **Percentage on Direct Material Method**

The direct material cost is one of the primary components for product cost. Under this method, the absorption rate is based on the direct material cost. To calculate this, divide the overheads by the estimated or actual direct material costs.

Percentage on Direct Material Cost =  $\text{Overhead} / \text{Direct Material Costs} \times 100$



- **Prime Cost Percentage Method**

The prime cost is the sum of direct labor and direct material costs of a business. To calculate the prime cost percentage, divide factory overhead by prime cost.

$$\text{Prime Cost Percentage} = \text{Overheads} / \text{Prime Cost} \times 100$$

- **Labor Hours Method**

The labor hour rate is calculated by dividing the factory overhead by direct labor hours.

The formula is:

$$\text{Labor Hour Rate} = \text{Overheads} / \text{Labor Hours}$$

- **Machine Hour Method**

Machine hour rate is calculated by dividing the factory overhead by machine hours.

$$\text{Machine Hour Rate} = \text{Overheads} / \text{Machine Hours}$$

- **Sale Price Method**

Under this method, budgeted overheads are divided by the sale price of units of production.

$$\text{Sale Price} = \text{Overheads} / \text{Sale Price of Production Units}$$



### **How to calculate overhead rate per employee**

To calculate the overhead rate per employee, follow the steps below:

- Calculate the labor cost which includes not just the weekly or hourly pay but also health benefits, vacation pay, pension and retirement benefits paid by the employer.
- Compute the total overheads of the business.
- Divide the overhead costs by the number of billable hours. For example, if your business has six technicians, the overhead costs are divided between them.
- Adding the overhead costs and the labor cost to billable hours gives you the net cost of that employee to the business per hour.

- The overhead rate or the overhead percentage is the amount your business spends on making a product or providing services to its customers. To calculate the overhead rate, divide the indirect costs by the direct costs and multiply by 100.
- If your overhead rate is 20%, it means the business spends 20% of its revenue on producing a good or providing services. A lower overhead rate indicates efficiency and more profits.





## **Special Video Training On This Subject**

For Special Video Training On This Subject,  
Including The Subject Of Pricing, And How To Price For Profits And Success

**Pricing For Profit**



## **How To Turn Around Any Business In 8 Simple Steps**

Or

### **The Secrets Method Of A Successful Turn Around Agent**

Mikkel Pitzner, founder and creator of The Automated Millionaire, its programs and its coaching, has been an entrepreneur all his adult life and his business endeavors have taken him and his activities all over. From initial activities in Denmark to activities in Sweden, Norway, Poland, Germany, England and the United States.

He has been engaged in all kinds of business from all industries and on all levels inside business.

Following obtaining the coveted Green Card, Mikkel soon commenced working with one of the largest and most successful business consulting companies in the US



and soon ranked among the top 3 consultants there among some 1,300 esteemed colleagues.

The time with the large consulting company rapidly exposed Mikkel to a huge multitude of companies from all kinds of industries and of all sizes, spread all throughout the US and Canada.

Most of these companies were in need of help. Many of the companies were downright struggling for survival, but in very short time with the help of Mikkel, these companies were soon on a new path towards prosperity.

*“Through all the experience of helping these companies, I learned some great insights.*

*One of these is the fact that actually most businesses can be turned around fast even if everything appears really doom and gloom. I also learned to even greater extent that in all businesses there’s cash to be found.*

*With the help of the consulting company and my brilliant colleagues I also learned a system, which I have now expanded upon to make it even more comprehensive. An accessible framework that can be used in any business, to turn it around or to make a great business even greater.*

*This framework and system truly is How To Turn Any Business Around In 8 Simple Steps.*

*The bases of this system or method has been successfully incorporated with several hundreds of thousands of businesses by me and many of my colleagues collectively.*

*It is HIGHLY EFFECTIVE and it just downright WORKS. I have yet to find a business in which it wouldn't work.*



*Want to access a quick overview of the 8 Simple Steps?*

*Just click the link below and I'll show you the method so you can incorporate it in your business now:*

- *Mikkel Pitzner*

**How To Turn Around Any  
Business In 8 Simple Steps**



## **About The Automated Millionaire**

The Automated Millionaire helps small and medium sized businesses achieve greater profits and more efficiently run operations without having to work harder and does so by implementing a specific business method called The Automated Millionaire Business System.

The Automated Millionaire is founded by Mikkel Pitzner, who is also the creator of The Automated Millionaire Programs and Coaching.

To Get A Free Taste Of Some Of The Insights Of The Automated Millionaire That You Can Use In Your Business Click The Button Below:

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## Further Resources

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