

Abstract: What a construction company spends on project management, repairs, small tools, office trailers and so forth can easily creep up on it. These *indirect* job costs — if not properly allocated to their projects — can cause overhead to increase and profitability to suffer. It's important to break down and analyze spending, and determine how indirect costs affect projects. A contractor should also review the amounts it's paying vendors. Set up correctly, an indirect-cost allocation system can help a contractor to bid projects more realistically and build up its bottom line.

Eliminate the creep!

How to manage indirect costs

What your construction company spends on project management, repairs, small tools, office trailers and so forth can easily creep up on you. These *indirect* job costs — if not properly allocated to their projects — can cause your overhead to increase and your profitability to suffer.

Overlooking indirect costs when preparing job estimates can cause a project to run over budget. Moreover, if you bid on a project and consider only the *direct* costs, you may win the contract, but you'll likely lose money in the long run. Let's take a closer look at how to track and recover indirect costs.

Gain insight on your spending

A good place to start is in your chart of accounts — it should break down indirect costs into enough categories to provide you with insight into these expenses. Then, with your CPA's help, analyze the information by performing a budget-to-actual analysis. This involves setting a budget amount (usually annually) through a review of previous years' costs, planning for the coming year and comparing the budgeted amount to your actual costs regularly. Set up the budget using up-to-date accounting software so you can run the budget vs. actual comparison at any time.

You can also benchmark your company's indirect costs to a peer group. Trade organizations may perform annual financial surveys that provide such information. Or you can work with a construction consultant who has access to a large database of contractor data. By gaining an understanding of the levels of indirect costs your peers are incurring, you'll have a better idea of the significance of indirect costs for your company.

Determine how costs affect projects

When you know what you're spending and how those numbers compare to your budget and to numbers from similar construction companies, you can start cutting your indirect costs. Using the data you've gathered, determine how each indirect cost contributes to your projects. Then identify which costs are fixed, which are variable and which are a little of both.

In addition, analyze how changes in your job types or volume affect your indirect costs. There may be some indirect costs that are more directly affected by the type or volume of your projects than you previously thought.

Look at outside costs

After looking inside, take a look outside to see whether you're incurring unnecessary (or unnecessarily high) indirect costs. This means reviewing the amounts you're paying vendors for items such as uniforms, utilities and technology.

Also consider whether any personal relationships you've established with vendors are hurting your bottom line. Granted, the vendor relationships that contractors build over time often play a huge role in their companies' success. Still, you need to make sure you're spending your indirect dollars wisely.

Scrutinize direct costs too

You likely are already doing a pretty good job of tracking your direct costs, such as labor, subcontractors, materials costs and equipment. It doesn't hurt to review your cost-tracking process, however, to make sure you're not overlooking anything.

One of the best ways to track direct costs is to assign every job a number and record that number with every cost incurred. Good job-costing software is a must to help you crunch the numbers and generate detailed profitability reports. Profit and loss, job cost, aged accounts receivable and aged accounts payable are examples of key reports that you should review each month. Look for places where you're over- or underbudget and adjust as needed.

Strive for realistic bids

Set up correctly, an indirect-cost allocation system can help you to bid projects more realistically and build up your bottom line. Give us a call; we're here to help you.