



READY-ACCESS TO TRUE COSTS WILL GUIDE PROFITABILITY

By Dan Stanhope, CPA

In construction, there is the phrase: “costs drive revenue,” meaning that the driver behind how you recognize revenue is your costs. Owners, estimators, project managers and accounting staff all need to fully comprehend a company’s true cost structure to clearly understand their financial position. This information needs to be presented to the appropriate people (management) in a timely manner so important business decisions can be made. These financial metrics and benchmarking activities guide companies to profitability.

Why is it so important to understand your true costs?

Just because your company is busy, doesn’t mean you are profitable. Knowing your company’s true cost structure is vital to your success. Cost structure is an important tool providing insights into: budgeting, allocating burden, pricing work, and working up change orders. Without a solid understanding of your true costs, you run the risk of tying up resources on jobs that are not profitable.

Anticipating Project Expenses

When budgeting/estimating for a job, if your true costs are unrealistic, you run the risk of carrying the wrong figures in the estimate. Anticipated project expenses must be carefully and accurately assessed and need to take into account direct costs and indirect costs.

Contract estimates should accurately represent the amount of direct costs, including labor, subcontractors, materials, supplies, equipment rental and other direct costs. Accounting for indirect costs is equally as important when working to enhance your bottom line. Depending on your line of business, costs such as contract supervision, indirect labor, union benefits (if applicable), employee benefits, payroll taxes, insurance, tools, equipment, fuel and depreciation can all be a significant portion of the overall job costs. I have heard clients

say: “if I carry the indirects in the budget we won’t get the job.” If that is true, the job might not be a good fit, or you should take a look at your indirect cost pool and determine if there are opportunities to reduce these expenses. Regardless, indirect costs are a part of doing business and a factor directly impacting profit margins.

To ensure you have accurate figures for these two buckets (direct and indirect), you need to obtain subcontractor/material quotes, estimate labor hours, review labor rates, and assess burden rates. This can be time consuming, but missing even one of these components could result in a lost opportunity, a job that leaves money on the table, a job that makes no profit, or—worst case—a job that loses money.

Allocating Burden

Burden is an important part of your cost structure. Burden is the means of taking all indirect costs and allocating these into specific jobs. In order for the work-in-process (WIP) schedule to be meaningful and useful, your finance department needs to have a handle on the burden rate, and ensure it is accurately allocated to projects. If not done properly, the WIP schedule could reflect margins that are significantly different than what is reported in your income statement. This could result in a few consequences: your WIP reflects that you are doing better/worse than actual, or you are reflecting an unrealistic picture and your CPA, surety, or bank could lose faith in your internal financials and WIP.

The Skinny on Pricing and Bidding

In the pricing/bidding stage, it’s important to understand how aggressive you can be. Without a clear picture of true costs, you could leave money on the table or price yourself out of the job completely. Knowing your true costs by line item can allow you to price each individual cost with a mark-up as opposed to

applying a global mark-up. You can have different mark-ups for each line item, or different mark-up tiers based on the complexity of the job. This break-down will help if you get in a "last look" situation and you need to "skinny the price." This break-down could also identify that you have already taken the profit out of the job and it would be in your best interest to bow out.

Change Orders

Project managers can more efficiently work up a change order if they have ready-access to the true cost structure, which also expedites approval and billing. The biggest issue with change orders is formal approval. Too often, change orders go unapproved while the work has already been "put in place," essentially providing the customer with extended credit terms. Often, out on a job a contractor will be asked to do something verbally and, because resources are in place and timing is right, they proceed with doing the work and thus incurring the costs. The risk here is that paperwork and approval can lag or the owner and contractor might not agree on the value or price. You can't bill for the change order until it is approved, and the longer it takes to get that formal approval the less likely you are of realizing the full value. There can be confusion between contractor and owner about what is in, and what is out of scope.

Why is it so important to have timely job costing?

Ready-Access to Costs

After a job has been awarded it is important that the cost reporting is set up to mirror how the job was estimated. This will help facilitate a post job review as well as assist the project managers in running the job from the initial kick off meeting to completion.

When measuring success, you need to keep score. If you have a solid job costing system, regular cost meetings will help identify problems that may present themselves in the numbers, such as: cost overruns, unapproved change orders, under-billing issues, and profit fade. Accurate and timely reporting and meetings allow project managers to gauge the stage of the job, update estimated costs to complete, and better manage resources to maximize profit margins.

Upon completion of a job, teams should meet to review the final job cost in comparison to the original estimate. This postmortem meeting will ensure that Estimating gets the

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feedback they need on the rates they have been carrying, the hours they anticipated the job to take vs actual, and if the buyout of the project was in line with expectations. This information will be useful when estimating the next job, and in driving improvements in efficiency and profitability.

It is critical that estimators, project managers and accounting departments have a handle on the company's true cost structure. Management should also stress the importance of monthly cost meetings so the team can review the cost reports and recommend necessary corrective actions.

If you're bidding on contracts without a clear understanding of the true costs, you're probably under-estimating project costs. Ready-access to true costs can help you to make more money per job, and to never leave money on the table. In order to build stronger, more profitable businesses, your team needs to have an accurate, clear and real-time picture of your company's financial position.



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If you have any questions or need additional information, please contact your AAF Partner, or **Dan Stanhope, CPA**, at 774.512.4134, dstanhope@aafcpa.com.



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