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For Survival at Next Level, 'Cost Accounting' Is Essential Practice for Construction Firms

By Perry Barnett, CPA

In the new economy, managing risk and capturing costs have never been more critical for business survival in today's embattled construction industry.

Whether a general contractor or a subcontractor, construction firms have been forced to clamp down on costs and account for every penny, particularly in estimating and bidding jobs, like never before. Ironically, many firms fail to discover the importance of this basic accounting practice until they begin to find success growing to the next level.

But for those business owners and operators who truly understand and adhere to the time-honored principles of cost accounting, it is their construction firms that will weather the recent storms and emerge far ahead of their competitors as the economy turns toward better days.

What is cost accounting?
Cost accounting is often confused with financial accounting, but there is a distinct difference. Cost accounting is much more focused on a specific area of business, such as an analysis of your cost of sales to produce a finished product. On the other hand, financial accounting is a much broader measure of a company's overall economic performance.

In the construction business, cost accounting specifically involves an examination of all potential costs before carrying out a certain activity – which typically means determining a selling price or performing a job estimate.

Don't always follow the norm
Times are different, and the times continue to change. In such a challenging environment, it's not always wise to adhere to past practices – particularly in your cost accounting – even if you are following traditional industry standards.

For example, in the old days (not so long ago), it was standard practice in the construction industry to factor in an established percent for business overhead when calculating a job bid. Then, to remain competitive, you would calculate a profit margin of between three and eight percent (unless the project involved higher skilled labor, of course).

As mentioned earlier, following these benchmarks may suffice for a young or start-up business, but overhead costs can shift rapidly as a company expands. New expenses such as a full-time estimator or more sophisticated job-tracking software may no longer be avoided once the company doubles in size.

In addition, with the tighter regulations in financial markets, surety companies are especially attentive to construction firms whose job cost estimates consistently fail to match up to final revenues. This "profit fade" can lead to difficulty in maintaining credibility in your business operations and securing future financing.

Consequently, blindly following industry norms – without adapting to your specific business situation – potentially can run you right out of business. You must be able to identify and capture every potential cost, not only what it takes to complete a specific job but what it takes to operate your business as well. Direct costs such as materials and labor are fairly obvious. The more difficult challenge comes in uncovering what is known as indirect costs.

The 'indirect costs' of doing business
Indirect costs involve such line items as health insurance, depreciation, and building rent. As such, these expenses are difficult to apply directly to a job estimate.

However, there are definitely some indirect costs that can justifiably be tied to a job – such as uniforms, vehicle fuel costs, equipment maintenance and repairs. Instead of listing these expenses individually, the smarter practice is to group them into an "indirect cost pool" that can be allocated by a certain percentage to each job.

If you haven't done so, the best place to start is to examine your previous year's financial statements. Identify your pool of indirect costs that were most closely associated to performing specific jobs, then include those calculations in your current budget and job estimating. Going forward, it will be important to examine this cost pool at least every quarter, if not monthly, to remain on track and as accurate as possible.

With cost accounting, your overall business goal is to retain flexibility with your profit margin in the estimating and bidding process. Once you have established a ceiling on all costs required to perform a construction job, then you can begin to make more educated decisions in your estimates and bids. You can decide whether to increase your profit margin, or even forego it in other instances, without risking your overall bottom line.

Getting a handle on costs
If your construction firm is growing but has remained tightly held and operated, it may be time to reach out for help. It's not easy to conduct cost accounting all on your own. Here are a few ideas that may help:

- One of the first steps you can take is to find a business mentor, someone who has been down your same road and is now operating a much larger construction firm, preferably outside your competitive market. Chances are that another business owner relied on outside advice as well to build their own successful business and would be happy to share their insights.

- Partnering with an accountant or other business consultant with specific experience in the construction industry is also advisable.

- As you work toward more accurate cost accounting, another initial step is to study your company's organizational chart and consider hiring an operations manager with specific experience in growing or operating a larger construction firm.

- Investing in greater automation through modular, integrated accounting software that is scalable to grow along with your company is another necessity toward honing your cost-accounting system.

- Phasing in development of your cost-accounting structure is typically advisable, especially if you're starting from scratch.

All of these steps require careful consideration and planning. But the desired outcome – learning to manage your profits as well as you manage your construction projects – will be most rewarding in the future growth and livelihood of your company and employees.

Perry Barnett is a partner with Rushton & Company, an accounting and business consulting firm based north of Atlanta in Gainesville, Ga. Barnett works closely with firms in the construction industry as well as specializing in tax and estate planning. His firm is a distinguished member of CPAmerica. www.RushtonandCompany.com