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The Value of Burden: Accounting for Indirect Cost Improves Performance and Profitability

By Robert Mercado and Adam Canosa | Thursday, March 21, 2019

UNDERSTANDING HARD COSTS AND BURDEN

When analyzing performance on construction projects, two significant aspects of cost, direct and indirect, must be considered. Direct cost, also referred to as hard cost, is easier to identify and consists of purchases made specifically for the intended project. Direct cost primarily includes materials, subcontractors, equipment rentals and direct labor. Indirect cost, often referred to as burden, is not as easy to discern. Indirect cost can be analyzed and accounted for in multiple ways. Understanding, analyzing and accounting for indirect costs on construction projects is crucial during the bidding process as well as in managing project performance and, hence, increasing project profitability.

DETERMINING DIRECT VS. INDIRECT COST

Distinguishing between direct and indirect cost is specific to the project. Insurance cost on a project is a good example. Certain projects require a specific insurance policy with rigid parameters. The premium is based on that specific project, and the policy runs the duration of the project. The premium for this type of insurance policy would be charged to the project as a direct cost.

Conversely, insurance cost that a contractor is required to carry, such as workers compensation insurance, would be considered an indirect cost. The premium paid for workers compensation insurance is paid each month and covers labor on all construction projects the contractor is performing during the policy period. This indirect cost would be required to be charged, or burdened, to each of the projects, using a burden rate.

Identifying indirect cost is vital to understanding the true cost of each construction project. The most common indirect costs relate to insurance premiums for general liability and workers compensation policies, and can include items such as depreciation expense, equipment repair and maintenance, vehicle expense including fuel, union expenses, small tools, cell phones and project management.

ANALYZING BURDEN

Once the indirect cost items are identified, an analysis can be performed by computing a burden rate based on historical averages of indirect cost. The burden rate can be calculated using some type of driver that provides the best basis to allocate indirect cost to a project. For example, if the construction company is a heavy equipment contractor, equipment hours could be the most relevant driver for burdening the projects. The calculation of the burden rate would be the annual indirect cost pool divided into the annual equipment hours. The resulting burden rate would be charged to a project for each equipment hour incurred on the project.

Other examples of methods of charging burden to a project are based on direct labor hours or on a combination of methods such as direct labor hours plus equipment hours. Contractors need to determine what drivers are most applicable to their specialty. This allows the best approach to charging burden to projects.

Once the burden rate is calculated, the analysis is computed by dividing the indirect cost for each month into the total equipment hours logged for the month. The difference in the burden rate will be the analytical mechanism used to manage indirect cost pools. It is important to note that this burden rate will vary significantly depending on when this analysis is performed and the nature of the contractor's business. Some contractors incur heavy repair costs early in the year when work is generally slower due to weather. When analyzing burden in the first quarter, it should not necessarily cause alarm if the rate increases because of the timing of when the significant portion of indirect costs are incurred. This example of the burden analysis perfectly highlights the importance of analyzing such burden and understanding your company's cost trends.

The accounting for burden is relatively straightforward once the above analysis of indirect cost is completed. Taking the above example of a contractor calculating the burden rate using total indirect cost divided by equipment hours, each project would be burdened with indirect cost by multiplying the burden rate times each machine hour logged on that project. Accounting for indirect cost can become difficult if the estimated total cost of the project does not accurately include all incurred burden to date, as well as anticipated future burden. An example would be the estimate of future machine hours to determine future burden, while computing estimates on cost-to-complete.

Calculating indirect costs in the initial stages of a project is time-consuming yet crucial. Investing the time to capture the burden rates and analyzing these costs to prepare and include on project bids allow for a significant benefit to the company. The financial results of each project will align more cohesively with actual performance, thus reducing any significant swings in financial reporting. Ensuring that the project estimating team can truly predict both direct and indirect costs secures more efficient bids. The company will then have more accurate data when securing new work to predict the profit the job will actually return once fully burdened. Companies should contact their accounting professional for further information regarding the calculation of indirect cost and burden rates.



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