



What Is Job Cost?

by Keith R. Fetridge

After 20 years of working with hundreds of different contractors, the one question I always hear is: "What should be charged to job cost? My controller tells me we should include X, Y, and Z in our job cost, but my project manager says that his former employer charged X, Y, Z, and the kitchen sink too. Who's right?"

As you may have already surmised, there is no simple answer that will fit every contractor's situation. The definitions and terminology vary within industry publications, and the application of what guidance does exist varies significantly between both CPAs and construction companies.

What does the applicable accounting literature say? The most current guidance comes from the AICPA's Statement of Position (SOP) 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts."

SOP 81-1 states that "contract costs should be accumulated in the same manner as inventory and charged to operations in the same period in which the associated contract revenue is recognized." *Contract costs* include all direct labor, subcontract, and material costs, in addition to indirect costs that are identifiable and allocable to the construction contract. What SOP 81-1 does not clearly address is the types of costs that are included within indirect costs.

It's Not as Simple as It Sounds

The difficulty in identifying and charging costs to jobs does not arise from identifying what direct costs should be allocated to job costs. The problems arise when contractors attempt to identify what *indirect costs* should be charged to a job and how those indirect costs should be allocated between their current jobs.

The issue of indirect costs lies with the term itself and how different people interpret it. For some, the term indirect cost means any cost not specifically identified to a particular project that must, therefore, be allocated

Exhibit 1:
Comparison of Job Cost with and without
Indirect Job Cost Allocations

Original Contract Budget

	No Indirect Cost Allocated <u>To Job Cost</u>	With Indirect Cost Allocated <u>To Job Cost</u>
Contract Amount	\$1,000,000	\$1,000,000
Direct Cost	(600,000)	(600,000)
Indirect Cost	<u>0</u>	<u>(300,000)</u>
Gross Profit	\$400,000	\$100,000

Actual Costs Incurred in Performance of Contract

	Year 1	Year 2	Total
Direct Costs Incurred	\$200,000	\$400,000	\$600,000
Indirect Costs Incurred	<u>\$200,000</u>	<u>\$100,000</u>	<u>\$300,000</u>
Totals	\$400,000	\$500,000	\$900,000

Calculation of Earned Revenue when
No Indirect Costs Are Allocated

Percent Complete	33.3%	66.6%	100.0%
Contract Revenue	\$333,000	\$667,000	\$1,000,000
Direct Contract Costs	<u>(200,000)</u>	<u>(400,000)</u>	<u>(600,000)</u>
Gross Profit	133,000	267,000	400,000
Indirect Costs Expensed As Period Costs	<u>(200,000)</u>	<u>(100,000)</u>	<u>(300,000)</u>
Net Income (Loss) before G&A Exp.	\$(67,000)	\$167,000	\$100,000

Calculation of Earned Revenues
when Indirect Costs Are Allocated

Percent Complete	44.4%	55.6%	100%
Contract Revenue	\$444,000	\$556,000	\$1,000,000
Direct Contract Costs	<u>(400,000)</u>	<u>(500,000)</u>	<u>(900,000)</u>
Gross Profit	44,000	56,000	100,000
Indirect Costs Incurred	<u>0</u>	<u>0</u>	<u>0</u>
Net Income (Loss) before G&A Exp.	\$44,000	\$56,000	\$100,000

according to a systematic methodology. To others, indirect costs include only *overhead* items, such as estimating, purchasing, etc., which are often referred to as *job overhead*.

For this discussion, I will use the second definition, which includes costs such as labor burden and equipment as direct costs and classifies costs such as general conditions, field overhead, and/or job overhead as indirect costs.

Why is it so important to know what costs belong to each job? The first and most important reason is that contract revenues earned for financial reporting purposes are generally computed based on the amount of contract costs incurred. That is, most contractors use the cost-to-cost method to determine the percentage of completion on individual jobs. As a result, the accumulation of actual job costs should correlate with the method used to derive the total job cost estimate. This enables the contractor to accurately measure profitability as the job progresses.

Second, many contractors use accumulated cost on jobs as a measure to determine what amount to bill; thus, if costs are understated, billings and cash flow may be negatively affected.

Third, when it comes time to prove a contractor's cost (for purposes of supporting costs included in time and materials or cost-plus type contracts, or for purposes of documenting change orders or claims), it is critical that the contractor's system of cost accumulation be the same as that used to estimate and price such work. Otherwise, it may be impossible to collect for all costs incurred.

Fourth, contractors' financial statements are subject to significant scrutiny by outside users, such as sureties and bankers, who often compare financial performance with industry benchmarks. If, for example, the contractor is including direct and/or indirect job costs in overhead rather than charging them to jobs, the contractor's overhead will appear excessive.

Thus, how and what costs are included in the job cost and job estimate affect not only the amount of revenue recognition, but also cash flow (due to underbilling for work completed) and profitability (due to the inability to include all cost incurred in the performance of the work).

Exhibit 1 shows what effect the allocation of indirect costs can have on revenue recognition and the distortion of profitability that occurs when indirect costs are not properly charged to job cost.

Direct Costs

Direct costs are relatively easy to identify and accumulate for most contractors. Direct costs can generally be defined as those elements of cost associated with the specific work to be put in place. The difficult aspect of identifying and allocating direct costs lies with the portion that must be accumulated in pools and allocated to job costs.

Some of the most commonly identifiable direct costs are:

- Actual labor wages and related payroll taxes (FICA/Medicare, FUTA, and SUTA), fringe benefits (pension, health insurance, life and disability), and insurance (workers' compensation and liability), etc.
- Charges, fees, and assessments incurred in the performance of a specific contract, including taxes, freight, storage costs, etc.

Exhibit 2:
**Sample Labor Burden Rate
Calculation and Allocation**

	<u>Superintendent</u>	<u>Carpenter</u>
Base Hourly Wage Rate	\$25.00	\$18.00
Burden Rates		
<u>Payroll taxes</u>		
FICA (including Medicare)	7.65%	7.65%
Unemployment taxes:		
Federal	2.00%	3.00%
State	1.00%	1.00%
Total Payroll Taxes	10.65%	11.65%
<u>Fringe Benefits</u>		
Health, Life, and Disability Insurance	10.50%	8.50%
Pension	6.00%	8.00%
Other	2.00%	6.00%
Total Fringe Benefits	18.50%	22.50%
<u>Insurance</u>		
Workers' Compensation	8.00%	12.50%
Liability	2.00%	4.50%
Other	.50%	.50%
Total Insurance	10.50%	17.50%
Total Labor Burden Rate %	39.65%	51.65%
Total Cost per Hour (Base rate x 1 + total labor burden rate %)	\$34.91	\$27.30

- Subcontractors' costs.
- Equipment (either owned or rented) used in the performance of the work. This includes both ownership and operating costs, such as depreciation, insurance, storage, taxes, licenses, maintenance, repairs, transportation, fuel, oil, tires, etc.
- Other costs – bonds, permits, etc.

Indirect Costs

The identification, accumulation, and allocation of indirect costs is by far the most difficult aspect of job costing. Practice varies greatly between individual contractors depending on the size and type of work being performed. What determines if a particular cost should be classified as an indirect job cost or as a G&A cost? To make that determination, ask yourself the following questions:

- 1) Does the cost relate to the performance of a particular job in progress?

- 2) Does the cost relate directly to the contractor's construction activities?

If the answer is "yes" to either of the questions, then the costs should generally be included as either direct or indirect job costs. If the costs are time-related, and do not relate to contracting activities, then they should be classified as overhead costs.

The types of costs that are typically included as indirect costs include:

- Project management salaries
- Estimating salaries and fringe benefits
- Safety salaries and associated costs
- Purchasing salaries
- Contract administration salaries
- Labor burden, including payroll taxes, fringe benefits, and insurance on the above salaries
- General condition costs such as field offices, utilities, and security
- Small tools, expendable supplies, and tools
- Shop drawings and plans
- Vehicle and communication costs
- Engineering and architectural costs
- Insurance – Builders' Risk, Umbrella policies
- Other costs associated with processing paperwork and/or accounting for the project

By their very nature, indirect costs require not only that you identify which costs fall into this classification, but also that you allocate these costs to individual contracts.

Cost Pools

Many costs in both the direct and indirect cost categories must be accumulated into separate cost pools and then allocated to the individual projects on some rational basis. For example, the cost of equipment storage, yard and/or shop facilities, or the cost of operating a separate contract administration or purchasing department cannot be specifically identified or costed to a particular project. But under our definition, the equipment costs would be classified as direct costs and the project administrative costs as indirect costs.

For these types of costs, the most common procedure used to allocate costs to individual projects is the use of a *cost pool*. Typically, contractors will accumulate costs into a number of different cost pools, such as:

- Labor burden
- Equipment ownership and operating costs
- Shop and yard costs
- Vehicle costs
- Job management overhead costs

Exhibit 3: Cost Type Identification and Allocation Methods

<u>Cost Item</u>	<u>Elements Included</u>	<u>Method of Cost Accumulation and Allocation</u>
Direct Labor:	Labor hours performing work	Directly charged as incurred
Labor Burden:	Direct or indirect labor benefits. FICA, FUTA, SUTA, workers' compensation, health, life, disability, pension, bonus, leave, training, downtime	Costs pooled and allocated as a percent or flat rate per labor hour or amount of labor – some items pooled separately or directly charged
Materials:	Materials incorporated into the work being performed	Directly charged as incurred
Materials Handling:	Warehouse direct and indirect labor costs, facility costs, insurance, transportation, taxes	Costs pooled and allocated as a percent of storage direct materials cost – sometimes separately identified and directly charged and/or allocated to specific contracts only
Subcontracts:	Subcontractors involved in the performance of work	Directly charged as incurred
Equipment Owned or Leased:	Ownership and operating costs of equipment used in the performance of work including depreciation, insurance, taxes, licenses, fees, storage, repairs and maintenance, transportation, fuel, oil, supplies, cost of capital, reserves, and shop facilities	Costs pooled and allocated to jobs based on hours used as a function of projected usage (weekly or monthly rates are optional)
Small Tools:	Expendable tools and reusable equipment and tools such as welders, scaffolding, saws and brooms; also includes repair, maintenance, and support costs	Costs pooled and allocated to jobs based on a fixed weekly/monthly rate or as a percentage of labor – sometimes directly charged to jobs as incurred depending on job size, duration, and value of item
Shop/Yard Costs (Non-Equipment Related):	Fabrication shop, storage costs for small tools equipment, materials, etc.	Pooled and allocated as a percent of direct labor or direct material fabricated – total cost depending on the cost type associated with the facilities usage
Misc. Job Costs:	Bonds, permits, fees, expendable supplies	Directly charged to jobs as incurred
General Conditions:	Indirect and direct costs related to the support of field construction activities including: project management, superintendents, security, project engineers, on-site clerical, on-site safety, cleanup, temporary facilities and roads, utilities, signage, insurance (builders' risk, general & umbrella liability), travel & entertainment, safety	Either charged with labor burden as cost incurred or cost accumulated in a pool and allocated as a percentage of labor or other costs
Job Overhead:	Estimating, purchasing, accounting, data processing incurred in connection with contract functions	Allocated portion of costs in connection with contract function pooled and allocated to jobs based on a percentage rate of labor, material combination, or total job costs

The development and use of cost pools requires the contractor to decide the following:

- 1) Which costs should be included as a job cost and in which pools should they be included?
- 2) How much of the cost should be included in the cost pool? In some cases, could the cost be allocated between job cost and overhead costs?
- 3) What method is most reasonable for allocating the cost to the jobs?

How you allocate indirect costs can vary depending on the type of work and amount of costs incurred. For example, a general contractor may choose to lump more costs together into one pool because they represent a very small percentage of total cost, while a subcontractor may use two or three separate cost pools for the same types of costs. What is

most important is that the costs be accumulated and allocated to all jobs on a rational, consistent, and systematic basis over all years.

Some of the most common methods for allocating costs to jobs include methods based upon the number of labor or equipment hours incurred or the amount of labor, material, or equipment costs.

An example of how the allocation percentages for determining labor burden amounts can be determined is included in Exhibit 2. Costs accumulated in this pool can relate to both direct and indirect labor costs, but the method of accumulating and allocating the labor burden should be the same for both direct and indirect labor costs.

The sample labor burden calculation in Exhibit 2 was developed using the percentage cost of each labor component to

calculate the amount applied to each labor hour incurred. Another method used to develop and then allocate cost pools involves accumulating all the costs incurred in one reporting period (typically a month or year) and dividing that total cost by the allocating factor. For example, the total equipment cost pool would be divided by total anticipated equipment usage hours to obtain an hourly rate, which would be used to allocate costs to jobs based on the actual usage of equipment.

Cost pools, by their very nature, involve the use of estimates and, as such, contractors may find that the costs included in these pools are often over/underapplied to jobs. Depending on the reason for the over/underapplied amount and the amount of over/underapplied cost in relation to the total cost of the contracts, the contractor may decide to reallocate these costs to jobs or recognize the amount as a cost item.

Exhibit 3 presents a list of the different cost types and allocation methods that can be used to allocate indirect costs to jobs.

Conclusion

Defining what costs should be included in job cost is a confusing area because contractors define direct and indirect costs differently and also use varying criteria for identifying which costs are considered indirect costs vs. overhead. The objectives which must be kept in mind when determining your company's job costing procedures should include the ability to:

- 1) Obtain a high degree of comparability between actual costs and estimated costs.
- 2) Bill and collect for all your costs.

- 3) Compare operating margins and overhead percentages with others in your industry segment.

If you make decisions and set up your job cost accounting system with these considerations in mind, chances are you will have good answers to the question: "What should be charged to job cost?"

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About the Author

Keith R. Fetridge, CPA, is a Managing Partner and Director of the Construction Industry Service Group of Aronson, Fetridge & Weigle, in Rockville, Maryland (e-mail: kfetridge@afwcpcpa.com or phone: 301-231-6203). Keith has more than 20 years experience in financial management, tax, and business consulting for all types of contractors.

Keith is a member of the Greater Washington, DC Chapter of CFMA, as well as several other construction-industry associations. He is a frequent lecturer on many different management, tax, and financial topics. He is the author of over 100 articles on contractor management and a co-author of R.S. Mean's Contractors Business Handbook, an editor and author of "The Contractor," and a contributing editor to Construction Today.

Keith earned his BS degree in Accounting from the School of Management of Boston College in 1976 and has been practicing accounting in the Washington, DC area ever since. He is a licensed CPA in the state of Maryland.