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Well-Insulated: Predict the Unpredictable Construction Costs

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It's clear that, at least for the next year or more, the construction industry can expect unpredictable cost variations.

What can construction companies do to insulate against cost fluctuations? How can they mitigate risks related to supply-chain issues, labor shortages, and increased cost and decreased availability of materials and labor?

Here are six strategies construction contractors and trade partners can adopt now to help minimize the impact of these economic uncertainties.

1. CONSIDER PRICE-ESCALATION CLAUSES OR COST-PLUS CONTRACTS, BOTH OF WHICH ALLOW THE CONTRACTOR TO PASS INCREASING MATERIAL AND LABOR COSTS ON TO THEIR CUSTOMERS.

Price-escalation clauses have typically been limited to cost increases for materials, but construction contractors can also use them to mitigate the risk of rising labor costs. This is an acute issue today, given the labor shortages and wage increases in the industry. Customers may try to negotiate out of price-escalation clauses, but the demand for their services means contractors have some leverage to push back against those demands – or contractors may need to be creative in negotiating price-escalation clauses.

2. FOCUS ON TIMELY AND ACCURATE REPORTING TO IDENTIFY EFFECTS OF COST INCREASES EARLY.

While construction contractors often have a good sense of when a particular job's costs have gone significantly over budget, timely and accurate reporting can enable them to know when relatively small cost increases are really starting to add up. With margins being squeezed, even small cost fluctuations can have a large impact on a company's bottom line. Contemporaneous job-cost accounting and reporting can help contractors identify even minor increases before they become a problem.

Rather than looking at profitability after a project has been completed, it's becoming more critical for contractors to review profitability for all jobs on a monthly basis. Both direct and indirect cost allocations should be considered, and the percentage of completion method of accounting should be used to recognize revenue.

Contractors can gain further insights by regularly comparing estimated contract costs to total contract costs incurred to identify where prices may be rising. Underbilled jobs can be an indicator of cost overruns that are masked by the fact that estimated costs haven't been updated for cost increases or labor inefficiencies.

As another benefit, contractors with accounting and reporting that's in top shape may find it easier to obtain financing and bonding. A contractor's skills at estimating costs and collecting revenue are key factors in those decisions. And orderly records give lending and bonding firms more confidence in the contractor's overall business practices.

If current technology or staff isn't able to provide timely accounting and reporting, it might make sense to outsource this function to a qualified third-party provider.

3. BRING CONTRACT COST INCREASES TO CUSTOMERS AS SOON AS POSSIBLE.

Timely cost allocation and revenue recognition make it easier for contractors to broach the topic of cost increases with customers. Once a job is complete, the contractor has little leverage to get the customer to cover higher-than-expected costs for labor or materials.

Accurate accounting, with proper documentation, can be a crucial part of pursuing cost-escalation clauses. A contractor who hasn't properly allocated costs, with solid records to support how they did so, might be less successful asserting a claim for additional compensation or defending against a customer's refusal to pay.

4. BE VIGILANT ABOUT TIMELY BILLING AND COLLECTIONS.

In times of economic uncertainty, it's especially important for contractors to quickly complete documentation, contractual and legal reminders or notices, invoicing authorizations, and billing. They should proactively notify customers about potential cost increases and even mildly delinquent invoice amounts.

With job delays common and the economy uncertain, trade partners may want to avoid entering contracts with "paid when paid" clauses, if possible. Given the high demand for qualified trade partners and ongoing labor shortages in the industry, they may have some negotiating power. When it's not possible to negotiate better payment schedules, they may at least be able to command higher margins.

General contractors and trade partners should aim for profit margins that are high enough to accommodate cash-flow issues that could result from long collection delays.

5. MANAGE COSTS BY INCENTIVIZING PROJECT MANAGERS TO MEET PROJECT PROFITABILITY GOALS.

Project managers with a stake in meeting profitability goals tend to be more hands-on about managing costs. That includes keeping an eye on labor hours, keeping the job on schedule, and quickly remediating delays, including securing materials and making sure trade partners are organized and onsite at the right time. Project managers should closely review all job accounting reports and quickly make course corrections or talk with management about passing on higher costs.

As an example, contractors should have controls and monitoring in place to minimize the risks of project managers taking unwanted actions to meet their profitability goals. It's important to ward against attempts at shifting costs from one job to another or keeping some costs outside the accounting system.

6. CONSIDER WHEN IT MAY MAKE SENSE TO OUTSOURCE ACCOUNTING AND REPORTING.

Accounting for construction contracts is one of the more specialized and technical methods of accounting, and contractors may find it challenging to hire and retain professionals with the right expertise. Having accounting personnel who understand the nuances of construction accounting and the importance of job costing is imperative to achieve accurate timely reporting. Sometimes the best way to find a team like this is to outsource to an accounting firm that already has a skilled construction accounting team.

There are other reasons a construction company might consider outsourcing this function, including the ability to access more advanced accounting software while gaining access to an experienced team of professionals who are already pros at using the latest technology. Growing construction companies may also benefit from a professional services firm's ability to grow with them.

With so many factors increasing pressure on construction industry cash flow and margins, contractors may need to revisit some of the processes in their accounting and financial operations. Construction companies that plan for, monitor, and respond to rising contract costs and economic changes are more likely to remain profitable in the current, dynamic economic environment.

About the Article

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