FINANCIAL REPORTING SERIES: OVERHEAD ALLOCATION

There are so many ways technology can help maximize profitability

BY MIKE ODE

FOUNDATION software

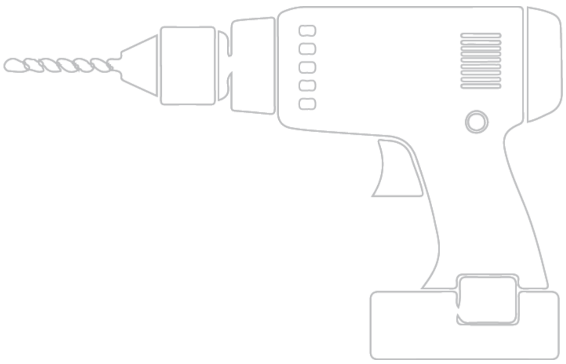
FINANCIAL REPORTING SERIES: OVERHEAD ALLOCATION

There are so many ways technology can help maximize profitability

Overhead allocation is one of the most misunderstood and challenging concepts that contractors face when running their businesses, but it's an essential task in determining a company's profitability. On the surface, overhead allocation seems simple. In addition to direct costs for materials, labor, burden, subcontractors and equipment, companies must account for indirect costs—or overhead. Today, many construction specific accounting systems can help contractors track overhead costs, calculate a ratio against actual expenses, and report this in a way that's understandable and accurate.

1. COMMIT TO DOING IT

Many contractors simply fail to allocate their indirect costs, and, of those that do, most perform a partial allocation at best. In either case, contractors see only a portion of their true job costs. To get a true account of a company's job costs, contractors must allocate indirect costs such as: office staff salaries, rent, utilities, marketing, advertising and more. The challenge lies in how to calculate the allocation of this type of overhead.



2. SELECT YOUR METHOD

Generally, two methods are used to allocate overhead in construction. Which method to use is a decision best made with the help and advice of a construction CPA or accounting professional.

FOUNDATION software

The first method is the "job-cost" method, which is simpler to use and understand but often less accurate. It uses a single, pre-determined rate, multiplied by the direct costs of the job to determine overhead costs. The rate is typically determined by using historical costs and working with an accountant to come up with the correct percentage.

The second, and preferred, method of overhead allocation is the "general ledger" method. While more complex, this method more accurately determines true overhead costs. Instead of using an estimated rate, the general ledger method requires contractors to track indirect costs in the same way that direct job costs are tracked. A percentage of those indirect costs is then allocated to each job based on the job's percentage of total actual costs. For example, if one job's costs represent 25% of the total costs on all jobs, that job receives 25% of the overhead expenses for the period. The general ledger method also allows for more complex formulas to accommodate "weighting" of overhead costs based on the types of costs that are most relevant to the contractor.

3. SIMPLIFY WITH TECHNOLOGY

Contractors who choose the general ledger method of overhead allocation are usually glad they spent the time determining the right formulas for their business. Depending on the size and type of jobs they perform, a flexible job cost system can allocate actual overhead costs by specific costs (labor, equipment, subcontract), by all costs, by job revenue, or by general ledger account.

Contractors who choose the job-cost method of overhead allocation will find that many software programs automatically allocate costs across jobs without any additional data entry. Regardless of which method a contractor chooses, accounting software can usually offer both "before" and "after" reports to help a contractor see the effect that overhead has on the bottom line. The software can also show the results for each job's profitability as well as for the company as a whole.

The real payoff in performing overhead allocation is the result. Contractors that use and understand overhead costs have a more accurate understanding of all costs. They're an important piece in the puzzle that, when put together, shows the real bottom line.

MIKE ODE
President
Foundation Software, Inc., of Strongsville, Ohio

He is the President of Foundation Software. Foundation Software is the developer of FOUNDATION for Windows and Payroll4Construction.com. Mike can be reached by phone at 800.246.0800, or by email at mode@foundationsoft.com.

Published in BX Magazine