Managing Project Overhead
The Factor Affecting Project Profitability

Seng Hansen
Master Student of Construction Contract Management UTM
Email: hansen_zinck@yahoo.co.id

Why Overhead?
Overhead costs can be defined as indirect expenses that cannot be charged to individual costs or bid items. It covers items such as directors’ fee, secretariat’s fee, marketing’s fee, general equipment costs, etc not only for project necessities but also for headquarters necessities. Therefore we can divided the overhead costs in 2 (two) types: project overhead and company overhead. Usually overhead costs are expressed in percentage of total direct cost and which then will be added into the contractor’s tender price. And since it cannot be charged as an individual cost, we cannot find this item in Bill of Quantities.

Another characteristic of overhead cost is that it will benefit more than one cost objective. So basically overhead is a summary of expenses which then will be used for the activity of some other works, not a cost which is used only for a particular work item. With this characteristic, overhead cost is usually spread to some related work items. Although these costs are not a component of the actual construction work, they have significant roles to support the work. Total overhead costs may vary from 10-30% of the total direct costs, depending on the project characteristics and company’s objectives.

As what I said earlier, there are two types of overhead costs; first is project overhead cost and the other is company overhead cost. Project overhead cost is the costs specific to a project, incurred for the sake of the construction process and execution. The examples of these project overhead costs are project administrative expenses, project office rent and utilities, project office supplies, project team’s salaries and bonuses, depreciation on project office equipments, taxes, bonds and insurances, the cost of rework, etc. While company overhead cost is all costs incurred by the construction firm in maintaining the business and supporting the production process, but are not related to a specific project. Office supplies, directors and company staff’s salaries and bonuses, depreciation on office equipments, company’s licenses, company’s advertising and marketing costs, training held by the company, etc are some of the example of this type. Unlike company overhead cost, the project overhead cost can be estimated in somewhat accuracy by checking and examining carefully all of the contract conditions and work’s specifications in a particular project. If the contractor or the Project Manager (with the help of a quantity surveyor) can do this estimation precisely, the project overhead costs can be determined in some accuracy, excluding the other unforeseen factors such as variations and force majeure. By doing this, hopefully the contractor’s team can manage their work and gain some profit accordingly.

While the company overhead cost is perhaps one of the main reason why there are so many contractors’ team cannot make a profit in their works. The company overhead costs will be charged into projects and usually it will effect to the project’s cash flow significantly. Here, it means that a project must bear two overhead costs; one from the project overhead costs itself and the other is from the company. Neglecting overhead costs can be a nightmare for Project Manager and his team because these costs constitute a significant portion of the total construction cost. What may be a profitable project can turn into a losser one.
Measuring Overhead
From my experience, it is not easy to measure overhead costs, especially if we are talking about project overhead costs which include company overhead costs. Let us see one by one the factors which effect these costs.

Factors affecting the company overhead costs are as follows:
1. Payments realization
   Payments realization is very important for the company’s cash flow. Delayed payments may increase company overhead costs which will eventually affect the project overhead costs. Therefore, it is very important to ensure the employers in issuing payments on time.
2. Availability of new projects
   The availability of new projects also affects the company overhead cost. If there is happened a shortage of new projects, the company overhead may increase for marketing purposes etc.
3. Inflations
   Inflations also can increase the company overhead costs.
4. Regulations
   Some new or changes of governmental regulations can affect the company overhead costs.

And now, factors affecting the project overhead costs are as follows:
1. Type of contract
   What contract type does the project have? A lump-sum contract will give different portion of overhead costs with joint venture contract.
2. Project complexity
   The more complex a project is, the more project overhead costs incurred. If you have a typical project, then you can save some expenses and this can reduce your project overhead costs.
3. Location and size
   Project location and size also affect the amount of project overhead costs. If the project is executed in urban areas will have more advantages rather than countryside projects. And usually, the bigger your project, the more overhead costs incurred (by the terms of amount, and not proportion).
4. Project duration
5. Payment schedule
6. Project’s cash availability
7. Employer’s strictness in supervision or nature of the clients
8. Subcontracted work
   How many percentage of the work is being subcontracted will affect your project overhead costs because usually you will spread your overhead costs in some work items. If these work items are being subcontracted, then you must bear your overhead costs more because you cannot include these costs in these work items anymore.
9. Number of competitors
10. The consultants involved

With its unpredictable nature, construction industry faces difficulty in deciding the optimum level of overhead costs that enables contractors to win and efficiently managing their projects. Since the construction industry is a multidiscipline industry, there will be many factors influencing the construction industry and eventually the project overhead. And unfortunately, these factors or activities are not yet clearly defined or accurately known. It is the major problem in measuring project overhead costs.

There are at least 3 (three) methods in measuring overhead costs. First method is by setting a percentage of overhead costs. Contractors who choose an easy way in measuring overhead costs by simply calculating the total direct costs and setting a percentage for overhead costs may end up in under or over estimating these costs. And this will affect to the accuracy of the contractor’s bidding price.
Another method that maybe used by contractors is by comparing the current project with similar projects which have been completed. Contractors may compare the similarities of project’s characteristics with other similar projects and conclude the amount of overhead costs (maybe in percentage or in a sum).

And the last method that I know is by checking contract requirements and estimating resources needed by the current project. Here, the contractors will need a particular person who has the experience to read the contract and measure the estimate expenses for overhead item. This method gives a more accurate estimation of overhead costs rather than the other two methods.

Managing Overhead
With the more global participation in this industry has made contractors to work in severely competitive conditions to deliver projects at the minimum cost, short duration and high quality as specified in the contract. This forces contractors to make a little profit. Therefore, the only way to stay in this industry is to reduce and control costs while maintaining the work’s quality. There are many way to reduce and control overhead costs.

The most common way done by contractors in managing their overhead costs is by simply cut their overhead costs. It appears to be the easiest way but actually does not give many benefits in doing so. Simply cutting overhead costs will not make you a profit. You just cut the costs but on the other hand, it means that you cut your capabilities to make more profit. By managing them, you will make profit. Moreover, if you wrongly choose overhead costs to be cut, you may end up in a more acute situation. There are some costs which can be reduced and some cannot. To manage these costs, project managers first must think that these costs are under their control and that they are not simply existed to be reduced or disappeared.

Below are some major problems in managing overhead costs:
1. All overhead costs as indirect activities are considered vital for the survival of the company or the project. Any reduction or cutting in these activities or quality will affect the company/project operation and eventually will affect the profit
2. Simply cutting overhead costs will affect executive officers first (both in company and project level). This sometimes causes a defensive mechanism to appear among top level management and may cause other problems to be appeared
3. Some companies lack in clear long term plans regarding business orientation. This can cause confusion regarding overhead spending priorities. The same applies to project level. Some projects do not give enough consideration in project planning.
4. Overhead is mainly a time-related expenses.

And the last question is about how to manage this overhead costs. Basically it comes back to the four principles of managing project: planning, organizing, actuating, and controlling. But it is never an easy task to manage a project, especially the project overhead costs which depend on many factors. Below are some important steps which should be considered in managing project overhead costs so that it will become an effective and efficient cost management:
1. Make planning and scheduling
   It is important to practicing proper project planning and scheduling in estimating overhead costs. By doing so, it will help to determine accurately the project duration and priorities which will eventually affect the overhead costs such as supervision and financing costs.
2. Understanding the distribution of overhead costs
   Make a target cost or budgeting, learn the overhead priorities and necessities, etc.
3. Cutting overhead costs
Reducing the size and staff of the project, renting facilities and accommodation instead of purchasing or building them, recruiting manpower with lower wages (usually under outsourcing employment contract), sharing office with other projects, reducing equipment and plant costs by selling surplus or unneeded equipments, reducing or cancelling overtime and bonuses, etc.

4. Improving productivity
Recruiting engineers and supervisors with high capabilities and determinations, using available resources whenever possible, etc.

5. Checking and controlling overhead costs
Checking variances to evaluate progress and taking necessary corrective actions, maintain progress as schedule, etc.