

DON'T LET OVERHEAD BE OVER YOUR HEAD

BY W. SCOTT TIDEMANN

We've all heard and used the term "overhead" in a generic sense to refer to various costs and fees associated with a construction project that are usually pooled together into a single cost-identification point. While overhead typically comprises 1% to 5% of a project's total value, it can sometimes become a much larger expense. I was once involved with a project where jobsite overhead was validated by a federal audit agency to be more than 35%.

This narrative addresses the subject of overhead in a detailed manner, and is intended to shed light on potential reasons why overhead should not be viewed and treated in the normally generic way to which most of us are accustomed.

In the context of construction, the term "overhead" often has alternate references, such as:

- Home Office overhead
- Home Office general & administrative costs
- Jobsite overhead costs
- Jobsite general & administrative costs
- Jobsite general conditions costs
- Jobsite general requirements costs
- Jobsite Division #1 costs

Revising our vocabulary of overhead as follows can make understanding the concept much simpler:

- Refer to Home Office overhead as Home Office General & Administrative (HOGA) costs
- Refer to Jobsite overhead as Jobsite General Conditions (JGC) costs

Since the beginning of the evolution of business, man has recognized the need to be able to identify specific costs as they have related to specific goods or actions, or were otherwise incurred in connection with certain goods or actions. JGC costs evolved as a matter of practicality, since an individual construction project is merely a microcosm of the larger business itself. As such, an individual construction project creates a need to be able to predict, track, and measure productivity and performance at direct and indirect levels.

The direct and indirect levels at which productivity or performance are predicted, tracked, and measured are wholly dependant upon the desires, needs, and abilities of the business. One business may wish to develop budgets and costs-tracking procedures and mechanisms at a different level and using different breakdowns than another identical type of business. These differences are recognized as optional and are virtually unlimited, especially regarding whether or not a cost is considered and classified as being direct or indirect. For example, one construction company may elect to classify and code its

concrete superintendent's time as a JGC costs, whereas another may elect to allocate, classify, and code the superintendent's time to the individual items or features of work. Either way is appropriate, as long as it adheres to the company's established and consistently followed accounting practices.

The following distinctions are the most depended-upon influences regarding the classification of a cost as being a direct cost or an indirect cost.

- **Direct cost:** A cost that can be identified with a particular work feature or activity, or with an item represented in the job cost accounting system (i.e., a single cost code).
- **Indirect cost:** A cost that can be identified as having benefited or supported more than one work feature, activity, or item and is, therefore, collected to an overhead pool of individual costs.

Note: In the federal government contracting arena, these terms have specific meanings that don't necessarily comport to the above definitions regarding an individual project or contract.

By way of example, imagine the following scenario:

A crane is to be used for lifting a concrete bucket to place the concrete on the second, third, and fourth floors of a parking garage. The crane is also to be used for lifting and placing a pre-fabricated metal walkway that spans the gap between the parking garage and a nearby office building. The crane expense can be coded as a direct cost in appropriate proportionate share to each of the different work activities (i.e., to the concrete deck placement activities for each of the different floor levels and to the walkway placement activity). Or, it can be coded as an indirect cost to a JGC pooled cost code. Both manners are at the contractor's discretion, and neither would be inappropriate or contrary to generally accepted accounting principles.

The potential exists in many construction contracting situations for misunderstanding, disagreement, or even bona fide dispute regarding the interpretation and application of overhead. This is primarily due to non-specific language in the contract regarding what is meant by the terms "overhead," "fee," "mark-up," "office," "field," "direct," "indirect," "time-driven," "time-related," "variable," "fixed," and "non-variable." Regarding fixed-price contracts, these terms generally only come into play when changes to the work are involved. In fact, it is likely that the only place a fixed-price contract will include or address the term "overhead" is in the contract clauses or provisions pertaining to changes to the work, delays, or time extensions. Of course, the contract language is considered to be rather innocuous and quite clear by any single reader or in-

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interpreter, until there is an after-the-fact disagreement between parties about word or phrase definitions.

While ambiguity of terms, phrases, and meanings has its own attendant dangers, the other extreme can be just as risky. Consider the following language excerpted from an actual contract:

“Allowance for overhead: This is defined as costs of any kind attributable to direct and indirect delay, acceleration, or impact, added to the total cost to Owner of any change in the Contract Sum but not to the cost of any change in the Contract Time for which contractor has been compensated pursuant to the conditions set forth in Section 7.03. This allowance shall compensate Contractor for all noncraft labor, temporary construction facilities, field engineering, schedule updating, as-built drawings, home office cost, office engineering, estimating costs, additional overhead because of the extended time, and any other cost incidental to the change in the Work.”

Such language can be an owner's and a contractor's nightmare in equal parts, but is likely a dream for their respective attorneys. Notwithstanding the various potential disputes that could arise due to language and meaning interpretation issues stemming from the above contract clause, the potential inequities arising from such language are equally varied. Especially when you consider the multitude and magnitude of differences that can exist between the types and nature of changes to the work that can occur.

For example, one change in the work can have a significant direct cost value, but no time-related element, such as a change to the type and grade of carpet that results in a doubling of the price of the carpet materials. Or, a change can result in little or no increase or decrease in direct costs, but can have a significant time impact, such as a change to the color of the carpet which will cost only minimally more (i.e., in the form of a re-order fee) but will delay delivery of the carpet and, therefore, the job for several weeks. With the first scenario, the owner pays handsomely via mark-ups on the increased direct costs (supposedly for overhead according to the above contract clause example); but with the second scenario, the contractor gets little or no compensation for the attendant delay or time extension. That is, unless the contract contains specific provisions regarding time-driven indirect costs, and how the contractor is or is not to be compensated for time-only or time-chiefly impacts or changes to the contract work or to the contract-specified performance period. Moreover, few and far between are the contracts that have any provisions addressing how an owner is to be rebated for the savings in time-driven contractor costs that might be realized by the contractor if a change results in a shortening of the performance period.

The above discussion pertains mostly to JGC costs, and equal consideration must be given to HOGA costs in relation to changes to the contract or contract work. The same theories and potential inequities apply. A standard percentage mark-up for overhead—whether it's specifically for home office or not, and whether it's in relation to a work-intensive but time-absent change order or not—can be significantly inequitable or can provide for significant economic gain for either party given the right set of circumstances.

Additionally, the concepts of over-absorbed, under-absorbed, or extended HOGA costs have long been recognized in the industry and are often calculated using a combination of mathematical calculations known in the industry as the Eichleay Formula. The formula has been alternately recognized, refused, used, and abused by numerous jurisdictions across the land, and its acceptability and applicability will continue to fluctuate dependant upon individual project particulars, governing jurisdictions, data variables, and individual philosophies. The one constant I have found is that, of the three existing versions of the formula, the version that is generally used is the one that best suits the needs of the party using it.

In summary, it can be concluded that there is likely a need for you to perform a detailed review of the contracts you proffer to see if they address your specific needs regarding overhead and the myriad of issues that can arise from non-specific contract language regarding what overhead is intended to mean versus what it can reasonably be interpreted to mean. Regarding reference to overhead, contracts should, at a minimum, include:

- Definitions addressing JGC costs and HOGA costs
- How each are to be calculated with respect to changes and delays
- Explanation as to what would entitle a contractor to be compensated additional amounts for increased costs that may be incurred in relation to JGC and HOGA

About the author

W. Scott Tidemann is Director of Claims Services for PinnacleOne's Phoenix operations and has more than 26 years of experience in a variety of capacities. He has worked with owners, contractors, subcontractors and legal counsel across the U.S. assisting with disputes, program development and management, contract administration, scheduling, negotiations, risk assessment and project estimate/cost analysis. He has also been a guest speaker for numerous national associations and organizations.