The Systech Blog

The Importance of Cost Control in Construction Contracts

A primary need of any contractor, or indeed any business, is to be profitable. Whilst profit alone does not guarantee survival – cash flow is critical too – the amount of profit a contractor makes is to a great extent within his gift. Having won a project, the contractor possesses a contractual obligation and an amount of money for discharging this obligation. In addition to taking steps to maximise value-recovery opportunities, whilst not forgetting to minimise the risks of deduction by way of set-off or liquidated damages, the contractor can also minimise his cost. Profit is the simple difference between value earned and cost spent.

Controlling cost is not easy with a myriad of people spending money on the contractor's behalf; from the project manager procuring big-ticket purchases and subcontracts, to the foreman buying sundry materials on a purchase card. Control of spend within the contractors organisation is crucial, but forget about subcontractor's costs at your peril! Although a subcontract may be let on a fixed price, the subcontractors too will be looking for ways to boost their income. Reducing the risk of subcontract cost growth by means of a well drafted subcontract agreement, and then managing it properly, is essential.

Project cost control is ideally commenced from the tendering stage. A contractor will typically have a cost system that contains a resource code structure used by the finance or accounts department. Where possible these codes should be applied to the resources included in the estimate simplifying the initial reconciliation between the 'estimate' and the 'working budget'. However flexibility to fine-tune is needed as the resource approach of the estimator may be somewhat different to the intentions of the project manager. Work estimated for delivery by the contractors own resources may be subcontracted, or material supply may be added to a subcontractor's scope for example. Irrespective, it is important that the estimate can be reconciled against a working budget and/or actual costs.

The contractor should utilise a cost planning tool that keeps track of 'cost to date' and 'forecast cost at completion' and, importantly, which identifies the reasons for discrete cost movements between the current and previous cost plans. This could simply be a formatted spreadsheet. Being able to readily identify changes in cost for particular resources is crucial, and will prompt questions over, for example, bad rates, operational inefficiency and unidentified scope changes. The change in cost, tracked cumulatively, and allocated as a 'recoverable' or 'non-recoverable' cost will help the contractor recognise positive and negative trends, reconcile the perception of recoverable cost with the reality of the variation register as part of a CVR report, and take proactive steps to avoid or mitigate potential cost escalations.

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An additional tier of capture is the use of a Work Breakdown Structure (WBS) to allocate particular budgets and actual spends to discrete sections of a project. Responsibility for a particular strand of the budget and its associated cost can be allocated to an accountable member of the delivery team.

The use of an effective cost coding, cost capture and WBS system will not only allow the contractor to proactively manage and minimise costs, but also help in the particularisation of costs should they need to be evidenced in support of a claim.

However, cost forecasting is an onerous task and will only be as reliable as the skills and experience of the forecaster. A failure to recognise a realistic cost to deliver the contracted obligations is fatal to confidence if cost-shocks occur. Remember that the contractor is looking for certainty of outcome as he must forecast results, risks and opportunities across many projects within the business. But the Employer is looking for certainty of outcome too and will not be receptive to unexpected increases as the contractor attempts to recover unexpected costs towards the end of the contract.

It is imperative that cost forecasts are compiled by responsible, experienced and accountable persons. The resources included must be linked to the current programme to ensure sufficiency with the work activities, along with a sensible contingency allowance. The forecast cost must be subjected to constructive scrutiny and justified progressively to senior management to ensure their confidence in the plans of the delivery team.

In conclusion, effective cost control coupled with realistic forecasting, subjected to regular review is imperative in order for the contractor to maximise his profitability.