

Essay on what could go wrong most likely risk areas

[Business](#), [Company](#)



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Analysis of Direct Material and Other Direct Costs

When pricing a contract, the analysis of projected direct costs is a most important factor in determining overall costs and therefore contract price to be tendered to the client, in order to ensure a profitable outcome at the completion of the contract. “ Direct” costs are those costs specifically attributable to the contract, for example materials, labor, travel, etc. In general, these direct costs are increased by a multiplying factor when determining pricing, in order to recover indirect costs, i. e. a proportion of the company’s operating costs / overheads.

Depending on the contract type, the direct costs and therefore the accurate analyses of them carry a greater or lesser degree of risk. For the purposes of this essay, a fixed price contract is assumed, whereby the contractor assumes the risks for potential costs overruns or escalation not covered by the contract terms. The Defense Acquisition University (DAU) website was used as a reference source for supporting direct costs analysis information.

In performing an analysis of the direct material, labor and other direct costs for any specific contract, the most likely sources of subsequent, unexpected cost increases are:

1. Escalation of actual unit costs of materials after the analysis was done;
2. Underestimating material quantities and/or labor hours needed;
3. Incurring unforeseen special costs (e. g. special tooling, rework of materials);
4. Contract variations imposed by the client but not excluded by the contract terms.

Escalation of Actual Unit Materials Costs. When unit costs are determined for inclusion in the costs analysis, to avoid escalations, ensure that costs used are firm, fixed for the likely period of the contract, and agreed in writing with the materials supplier(s). Also, ensure that any associated collateral costs (materials processing, assembly of component parts, delivery, insurance, etc.) have been included or allowances made for them.

Underestimating Material Quantities and/or Labor Hours. This possibility is more likely to occur if detailed direct material / labor cost estimates have not been prepared. Such estimates are crucially important, especially where large quantities of materials and/or large numbers of labor hours are involved, as even a moderate percentage overrun of either can represent a significant cost impact. Apart from ensuring that detailed estimates are done, remember to allow a moderate excess when ordering materials to allow for losses and/or breakages – the excess materials (if any remain) will

usually have some residual value. Also, a good technique is to compare with other completed contracts of a similar nature, to give a greater degree of confidence, particularly in the case of estimating labor hours.

Incurring Unforeseen Special Costs. The solution to this potential risk area is quite simply to avoid unforeseen costs as far as humanly possible. If the contract is well-drafted, unforeseen costs (e. g. for materials and/or labor tasks not written into the contract) can be excluded. In the event they still arise, the contractor is therefore in a position to negotiate with the client for a variation cost to be added to the original contract value.

Contract Variations Imposed by Client but not Excluded by the Contract Terms. If these circumstances arise, you probably have to blame your own company for not being careful enough in analysing costs when drafting the contract. There is then no solution other than to either ask the client nicely if they can agree a compromise, or simply bite the bullet and suffer the additional costs. Better still – make sure the contract is well-written!

Conclusion

It is clear that careful drafting of the contract coupled with detailed cost estimates and cost analyses for direct materials, labor and other direct costs are the most important factors in avoiding unanticipated cost escalations and consequent reduced profits or even losses. In addition to those measures, comparisons with previous, similar contracts will give a greater degree of confidence in the calculated costs for the current contract.

References:

Defense Acquisition University (DAU). Acquisition Community Connection. (2010). Ch 6 - Analyzing Direct Material Costs; Ch 7 - Analyzing Direct Labor Costs; Ch 8 - Analyzing Other Direct Costs. Retrieved from <https://acc.dau.mil/CommunityBrowser.aspx?id=379511&en-US>