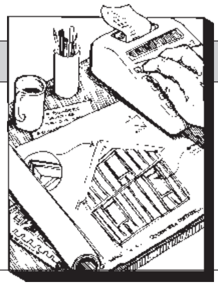

Using Allowances to Recover Your Costs

by Sal Alfano

Often you have to begin construction before you know exactly what it is you're building. In situations like this, pricing certain items "on allowance" can save the day, as long as all parties properly understand the concept.

An allowance is useful when work is anticipated, but its extent remains unknown. Soil tests may have determined the existence of concealed ledge, for example, but how much ledge is there and how it will interfere with the foundation is unknown.

Another common situation develops when certain items are included in the drawings and the contract, but are not specified. For instance, the owner may know the location and quantity of kitchen cabinets, but has not yet decided what kind of cabinet to use. The same is often true of lighting fixtures: they're in the drawings, but no one knows what kind of fixture goes where.

In almost every case, using allowances is preferable to simply leaving out the items that are still undetermined. For one thing, construction can begin before all of the details are nailed down.

An allowance gives the owner a fairly accurate idea of the actual cost of the project, thus reducing the size of "hidden costs." And it gives the contractor a more complete idea of the scope of the job, permitting accurate pricing and scheduling.

Which Type of Allowance?

Allowances come in several flavors. A *material allowance* affects only material cost. The labor to install, as well as overhead and profit, are figured into the base price agreed upon in the contract. This kind of allowance is commonly used when the class of material is known, but the type is not yet determined.

The owner may, for example, know that the living room will be carpeted, but hasn't chosen a carpet, so a material allowance of, say, $15 per square yard is included in the contract, subject to change when the specific carpet is chosen. Since carpet is carpet, installation costs are fixed, and are included as part of the base price.

A *labor allowance* is similar: only labor is affected. In the case of concealed ledge, it may be impossible to know how many cubic yards of ledge will have to be removed, but it is possible to calculate the cost of removing a single cubic yard. Consequently, an allowance price of, for instance, $60 per cubic yard can be included in the contract.

The final two types of allowance prices are combinations of the first two. The *material and installation allowance* includes both labor and material, leaving only overhead and profit in the base price. The *total-cost allowance* includes everything—labor, material, overhead and profit—and nothing is carried in the base price.

Every allowance price eventually is transformed into a change order. When the cabinets and light fixtures and carpet finally are chosen, and the backhoe crunches into solid rock, the allowance price begins to shed its skin and change into a hard price.

This price change has important consequences. A material allowance will allow change only with respect to the material costs. If the carpet costs $10 per square yard instead of the $15 per square yard allowed, a change order showing a net deduction of $5 per square yard will be written. Likewise, there will be a labor allowance and so on, on down the line.

Overhead and Profit

Which type of allowance is best for the builder? The total-cost allowance is best, and here's why.

In the other three types, your overhead and profit is fixed and is unaffected by the change order. Since your overhead and profit covers, among other things, certain kinds of losses which can occur on any job, your exposure to these losses can increase dramatically if the material choices made by the owner are priced well above what was allowed. And experience teaches that in most cases allowances are low, and change orders show an *increase* in costs, not a decrease.

Take kitchen cabinets again. Several years ago, I entered into a contract that had a $5,000 total-cost allowance for all kitchen cabinets and bathroom vanities. The cabinets the owner ultimately chose actually cost more than $15,000, not because there were more cabinets, but because each one was more expensive.

Damaging a cabinet during installation is not uncommon, and the only place to recoup the loss is in overhead and profit. Unless the basis for overhead and profit is tied to the actual cost of the allowance items, you are taking a big risk. Had I been operating under a simple material allowance, I would have been three times as vulnerable as I thought I was when I signed the contract.

Liability and property-damage insurance also is affected. Since your work product is almost always excluded from any claims adjustment, you will have to repair or replace it out-of-pocket if damage occurs through your negligence.

Again, overhead and profit is your chief resource. If the use of allowance prices is increasing your gross receipts without a proportional increase in overhead and profit, you are selling yourself short.

If the use of allowance prices is increasing your gross receipts without a proportional increase in overhead and profit, you are selling yourself short.

The loss need not occur on the job where a particular allowance is used, because your overhead and profit is cumulative, job to job, season to season. It doesn't matter when the loss occurs or what your volume is for a particular year: you still are liable for all completed work, year after year.

An allowance price that fixes your pverhead and profit before the actual costs are determined also can cost you money if the work covered by the allowance causes scheduling delays. Delays often make your crews less productive and increase your management time while you shuffle schedules. And delays can carry over from the current project to all future projects that season. A modest allowance can blossom into a high-priced change order, and you should be compensated for the extra time it will take to complete the work.

The type of allowance always is important. I once built a staircase on the basis of a total-cost allowance that was extremely low because the architect and the owner had no idea what they wanted at the time the contract was signed. The final design and detailing approved by the owner quadrupled the allowance price. The stair itself required three subcontractors, as well as labor from my own crew, and took a great deal longer than expected, resulting in schedule revisions. Had the allowance fixed my overhead and profit, the change order never would have covered these extra costs.

Finally, adjusting the allowance price always involves extra management time for the contractor. After all, the reason the carpet wasn't chosen was that nobody took the time to show samples. That job will invariably fall to you, and you ought to be able to include those charges in the change order.

The allowance is a necessary and practical solution to common problems in contract specification. But, depending on the nature of the work affected, the type of allowance used can have serious consequences for the builder.

Be careful to include in the base price all costs that are excluded from the allowance, and negotiate to change the type or amount of the allowance if you foresee problems. ■

Sal Alfano is a general contractor living in East Calais, Vt.