



Beware T&M Work

by Judith Miller

Many builders show their disdain for the competitive bidding process by declaring "I only do time and materials work." While T&M protects you from certain risks, such as underbidding your labor or missing change orders, I've come to believe that T&M work can be every bit as dangerous as competitive bidding, but in different ways.

Two very different billing arrangements are often lumped together under this broad heading. One variation, called cost-plus, usually includes a "not-to-exceed" budget to limit project cost. Materials and subcontractors are billed at invoice cost; hourly labor charges include labor burden; and overhead and profit, sometimes called a "contractor's fee," are broken out separately.

In another variation, labor is usually billed the same way, but often there is no limit to the total cost of the project. Overhead and profit may be mixed into charges for materials and subs, or called out separately, or both.

Fuzzy contracts. Regardless of the method used, T&M work has several pitfalls. The first danger is vague contract language. Recently I was called as an expert witness in a T&M arbitration case. The T&M contract for a \$250,000 addition called for 15% overhead and 8% profit. The owner withheld the last two payments solely because the overhead percentage was higher than the 10% he'd heard was "standard."

A year later when the matter went to arbitration, the issue was confused by the discovery that the contractor's true overhead of around 18% was unrelated to the overhead defined in the contract. We eventually demonstrated that it is common practice to include some overhead costs in labor charges, although this was not clearly stated in the contract.

Even though my client won the case, a different arbitrator in a different state might have reached the opposite conclusion. The victory was expensive, since it took another year to collect the judgment (without interest), and the

contractor lost at least one good job that he didn't have time to bid or supervise during the arbitration.

A simple "rate sheet" attached to the contract would have solved this problem by defining billing rates for each type of worker on the job. Alternatively, the contract should clearly state that labor rates include employer taxes, workers comp insurance, a portion of general liability insurance, and other benefit costs, such as health insurance and a small tool allowance.

Insufficient overhead. The second danger in T&M work is the failure to charge enough overhead to cover actual costs. Inexperienced builders assume that the "standard" margins of 10% to 12% overhead and 5% to 7% profit are sufficient to run a successful construction company. But if you need a gross profit margin of between 20% and 30% (see *Business Forum*, 2/95), a gross profit margin of 15% to 19% falls short of the mark. A builder who consistently undercharges will have no true profit and will continually face cash shortages.

For example, consider a builder with \$250,000 in total sales, a salary of \$40,000, and a target of \$12,500 (5%) profit. If overhead is a very lean \$20,000 (8%), this builder must earn \$290 per day, or \$36.25 per hour, to meet those goals. This may seem easy to builders who pound nails all day and can bill 40 hours a week, 50 weeks a year. But as your business grows and you delegate production to others, you will still need to generate \$290 per day with fewer billable hours with which to do it.

Some builders add a percentage to their employees' hourly T&M labor rate to cover supervision and administrative time. But this may still create a shortfall, because the dollar value of the percentage varies depending on the wage rates of the particular crew producing the job. A safer approach — and one that's easier to explain to your clients — is to provide a line item for supervision in your T&M statement. Include not only the

job foreman's supervision time, but every hour you, the company owner, spend scheduling subs, ordering material, and performing other administrative duties.

Wages only. The third danger of T&M relates to the second: T&M tends to keep construction company owners in wage positions, not management positions. Because most T&M builders work in the field themselves, they fail to develop the systems that are essential to larger operations. This practice makes it difficult to take on more than one job at a time, so the only way to increase profit is to increase the hourly rate for labor. But even the finest artisan soon reaches the maximum rate for his market.

Efficiency suffers. Finally, like all types of construction, T&M work requires a committed team of skilled employees. But without the time and budget constraints imposed by a fixed-price contract, efficiency often suffers. Quality seldom drops, but speed slows to a crawl. This often leads to client complaints about the lagging schedule and high labor costs.

In spite of these difficulties, some builders have been successful using T&M contracts. They follow a few simple rules to protect themselves from the pitfalls:

- Review all contract language with an attorney to remove words and phrases that might cause confusion, particularly with regard to billing.
- Cover your salary and provide sufficient overhead and profit for your company.
- Delegate authority to the site foreman. Create systems that will enable you to manage your jobs better and maintain high production efficiency.
- Before contracting an entire project on T&M billing, try it out on change orders and allowances. ■

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