ALLOWANCE PRICING THAT WORKS

by Sal Alfano

Clear specifications and written change orders are the answer when clients exceed allowance prices

In a perfect world, every detail of a construction project would be nailed down by the time the contract is signed. In practice, however, there is always something — a choice of countertop material, a kitchen cabinet style, a type of lockset or lighting fixture — that is still up in the air when the project starts.

Whether you're working from in-house designs or architectural plans, a common solution to this problem is the use of allowance prices. When used properly, allowances give both owners and contractors a reasonably accurate idea of the final cost of a project. Used carelessly, however, allowances can cause misunderstandings that result in unhappy clients and lost contractor profits. In this article, I'll explain the ins and outs of proper allowance pricing and point out the most common pitfalls.

What Is an Allowance?

An allowance price is simply a cost estimate for materials, products, or tasks that are still undetermined when the contract is signed. They enable you to set a total price for the work and begin construction despite the fact that some decisions remain to be made. Allowances are most common in a fixed-price contract, but cost-plus and even time-and-material contracts can contain allowances if the contract includes a guaranteed maximum or not-to-exceed cost.

Product and material selections. Allowances are most commonly used when a client or a client's designer or architect has not yet made a final decision about which product or material to use. These typically include floor coverings, countertop material, kitchen and bath cabinet styles, light fixtures, and plumbing fixtures and fittings. Occasionally, clients postpone decisions about roofing, siding, or similar finish materials, and these can also be handled with an allowance.

Unknown conditions. Sometimes the construction contract is signed before all decisions are made about the scope of the work, or about specific details. This typically occurs

when projects are fast-tracked and work begins before the plans have been completed; in this case, allowances are used to cover the cost of certain building elements, such as built-in cabinets or shelving, stairs, and custom shower enclosures.

Allowances can also be used when specific details about a known condition are incomplete or unknown. For example, a site may have concealed ledge of which all parties are aware, but the depth and extent of the ledge is unknown until excavation actually begins. A drilled well is another example, since the ultimate depth of the well is unknown until it is actually drilled. The same is true of an engineered septic system for which the need is known, but for which the specific design is not available when construction begins. In each case, an allowance price is included in the contract to provide a more accurate picture of the total cost than would be possible if prices for these kinds of items were omitted.

Material and Labor Only

The biggest question with regard to an allowance price is what to do with contractor gross profit (overhead plus net profit). Most of the AIA contracts I worked with employed a simple type of allowance that provided a price only for material or labor or both, while contractor gross profit was included in the base bid.

Cabinet Costs: Before and After

Contract Item	Cost	Gross Profit (25%)
Kitchen Labor	$2,500	$833
Material-Only Allowance	$5,000	$1,667
Total before cabinets were selected	$7,500	$2,500

Contract Item	Cost	Gross Profit (25%)
Kitchen Labor	$2,500	$833
Actual Cabinets	$13,000	$4,333
Total after cabinets were selected	$15,500	$5,166
Gross Profit Shortfall		($2,666)

The first set of numbers shows how the costs for kitchen cabinets were calculated in the original contract. The second set of numbers shows how the contract would have been calculated had the cabinets that the owner ultimately chose been specified. The more expensive cabinets entitle the contractor to a larger gross profit; a material-only allowance results in a gross profit shortfall of $2,666.

For example, a material-only allowance of $8 per square foot for floor tile means, first, that the particular tile to be used is still undetermined; and second, that the contract price covers tile costing up to $8 per square foot. Labor to install and contractor gross profit are included in the base price for construction no matter what the tile itself actually costs.

The same is true of a labor-only allowance. I usually ran into this kind of allowance on projects for which the owner wanted to purchase the light fixtures separately, but wanted me to install them. The allowance included a price to install — say, $25 per fixture — but my gross profit was included in the base bid.

Cost overruns. At first glance, these arrangements appear simple and troublefree. The owners shop for tile, find material they like for $8 per square foot, and the contractor orders and installs it. In the case of the light fixtures, the owner simply delivers the fixtures at the appropriate stage of construction and the electrician installs them. What could go wrong?

Plenty. Problems arise with material-only allowances when the client chooses materials or products whose cost exceeds the allowance, or, with a labor-only allowance, when the cost to install exceeds the estimated amount.

The first time I ran into this was when a client of mine selected top-of-the-line kitchen cabinets costing $13,000, while the architect had provided a material-only allowance of just $5,000. To cover this part of the kitchen work, my fixed-price contract included a total of $10,000: $5,000 for the cabinets themselves, $2,500 for installation, plus $2,500 gross profit (25%) on the total. My client's choice of cabinet manufacturer and style didn't affect labor costs, since he hadn't increased the number of cabinets. But because he chose more expensive cabinets, my gross profit on material was suddenly $2,666 too low (see chart at left).

The architect wanted me simply to add the additional $8,000 cost for the cabinets to my contract price, with no adjustment to gross profit. And if the cost variation had been smaller, I probably would have. For example, if the material-only allowance had been $8 per square foot for tile for a 5x10-foot entry and the owner had spent $9 per square foot, I would have gladly charged only the extra $50 — $1 for every square foot of tile.

But these kitchen cabinets were substantially more expensive, and I would be taking on a much larger responsibility while installing them. If I damaged a cabinet and had to repair or replace it, my costs would be higher than for cabinets that matched the original allowance price. The same is true of plumbing fixtures, countertops, floor coverings, even finish trim materials, all of which can easily exceed allowance prices by 200%, 300%, or more.

Labor-only overruns. Labor-only allowances can create the same problem. Say your client plans to purchase light fixtures, but wants you to install them. If the client buys simple surface-mounted ceiling fixtures or pendants, a labor-only allowance of $25 per fixture is probably adequate. Not so, however, if the client buys a crystal chandelier or a fixture with several pendant globes, each of which can cost four or five times that much to install.

In each case, your risk with regard to the material or labor increases, because you are liable for repair and replacement of more expensive material or for products that are more time-consuming to install. Yet the material-only or labor-only allowance prevents you from collecting any additional gross profit.

Deducts. The reverse is also true, of course. If your client chooses less expensive material or products that take less time to install, gross profit should be lower. As with overruns, small deductions can be refunded without affecting gross profit. But when the amount spent is significantly lower, savvy clients will look for a reduction in gross profit as well.

Strategies

Faced with material-only or labor-only allowances, you can adopt one of several strategies, depending on how you like to do business. If you prefer not to disclose your gross profit percentage to your clients, you can simply take your lumps when the client chooses more expensive options. Or you can pad your base bid with a contingency amount that might cover some or all of the overruns caused by a client's product selections. But in a competitive bid, you risk bidding too high and losing the job.

Specify all allowances. The safest alternative is to specify particular products that the allowance is intended to cover. If the client chooses a different product, write a change order that explains the new specification and adjusts both the material or labor cost, as well as your gross profit. This system should work even for contractors who don't like to reveal their gross profit percentages, because a fixed-price contract should always include a change order clause that provides for overhead and profit (see *Business Forum*, 6/95).

Allowing for Labor

Any allowance that includes labor should cover the cost of labor burden, such as federal and state withholding, unemployment insurance, workers comp, and other costs of maintaining employees. This will both reduce the size of the gross profit percentage you need to charge (see *Business Forum*, 3/95) and ensure that all of your costs are covered no matter which products or materials your client ultimately decides to use. This is true of a lump-sum allowance that includes some labor, but it's especially important for an allowance that uses hourly or "per each" labor figures. That way, if your client chooses materials or products that require more time to install, as in the example of light fixture installation, you'll be covered. If you leave these costs out of the allowance, you're bound to lose money, just as you will if all of your gross profit for allowances is kept in the base bid.

A clear specification for allowances also eliminates the need to make any adjustments for less expensive choices, providing you have done your homework and know for certain that the materials and products you specify fall within the price range allowed. Finally, using this change order process also indicates clearly to your client that the allowance is a budget to which they must adhere, instead of a limit on what you can charge for the choices they make.

Pricing Allowances

Allowances treated this way can still backfire if the original allowance price is much too low. Low allowance prices may win bids, but you will ultimately lose the goodwill of your client. In my case, the architect provided the $5,000 allowance. While cabinets were, in fact, available for that price, the overall quality of the job was higher and my client wasn't about to skimp on cabinets.

Match quality. But in many instances, you will be setting your own allowance prices. Instead of using the lowest price you can find, try to match the allowance price to the quality of the rest of the project. The goal is to put enough money into the allowance to meet the client's needs without either low-balling or pricing yourself out of the job. Use common sense — a lockset allowance of $10 per door may work for hollow-core lauan doors, but you'll need to allow $60 per door or more for locksets in custom hardwood doors. Similarly, a client who chooses a top-of-the-line

Putting a Price on Allowances

When it comes to attaching prices to allowance items, some methods of pricing are better than others. A lump sum may work for kitchen cabinets, but a unit price is often easier for your client to understand when it's time to go shopping. Here are some recommendations for how to price allowances.

Allowance item	Pricing Method	Minimum Specification
Cabinets & Countertops (cabinet layout known)	Lump sum	Cabinet manuf., style, countertop material, depth, backsplash ht., edge detail
(cabinet layout unknown)	$/LF wall + base	Cabinet manuf., style, countertop material, depth, backsplash ht., edge detail
Floor Tile	$/SF	Manuf., tile size, total sq. ft. to cover
Light Fixtures	$/EA	Manuf., model #, trim #, lamps included/not included
Plumbing Fixtures	$/EA	Manuf., model #, color
Plumbing Fittings	$/EA	Manuf., model #, finish
Built-in Shelving	Lump sum or $/LF	Material, adjustable or fixed, total wall area
Carpet	$/SY	Manuf., style, type of pad, total sq. yards
Sheet Flooring	$/SY	Manuf., style, trim, total sq. yards
Locksets	$/EA	Manuf., style, finish, function (entry, passage, etc.)
Trim	$/LF	Species, dimensions, profile, finish
Roofing	$/SQ	Manuf., style, flashing included/not included
Ledge Removal	$/CY	Method of measure (haulage vs. size of excavation)
Labor	$/HR	Specify activity, number of workers
Electrical Devices	$/BX	Count each switch, outlet, or light; installed price, type/color of cover plate
Well Drilling	$/LF	Separate LF figures with and without casing, limits of work (pump, wiring, etc.)

kitchen cabinet will probably need a countertop allowance that covers the cost of solid surfacing.

Don't guess. Above all, don't use a seat-of-the-pants price. Call around for prices on the allowance items you specify so that there are no surprises. If the cabinets you specify, for example, are the ones on sale at the lumberyard, you'll have a tough time selling a change order to your client.

Be flexible. Finally, don't nickel and dime a client whose product choices occasionally exceed the allowance by a small amount. Always use the change order process — you don't want to set a precedent for ignoring overruns — but mark the invoice "No Charge." Your client will still take your allowance prices seriously, but you'll gain points for goodwill.

What happened on the job with the expensive cabinets? I wrote a change order for the difference and my client paid it, including the increased gross profit. But I didn't make a fuss when the chandelier he delivered to the site a week later took all morning to install. ■

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