

Making Allowances Work

by Tom Peterson

Using item allowances in contracts for residential and light commercial construction has been a common practice for years. Allowance figures enable both the contractor and client to establish budget “place holders” for certain project details that may not be decided at the time of contract signing. But allowances can create pitfalls for both parties if they aren’t handled correctly. Following a few simple guidelines for using allowances will help you to provide excellent service and value for your clients while protecting your bottom line at the same time.

Strive for Accuracy

I have seen numerous situations where specifications and contracts stated allowances that were much too low to meet the client’s needs — an \$800 finish flooring allowance for a 2,800-square-foot new home, for example, or a \$1,500 appliance allowance for a high-end kitchen remodel. Veteran contractors know these numbers are ridiculously low, but the unsuspecting client may not discover how inadequate these allowances are until the project is half-complete. The client then spends the second half of the project scrambling to close the gap between the allowance price and the real price. This situation puts additional strain on the contractor/client relationship.

It’s your job to make sure the customer is working with accurate allowance numbers. From a business point of view, it’s shortsighted to do otherwise, because many of today’s savvy consumers simply won’t do business with a contractor who doesn’t

use realistic allowance figures, even if the contract price looks enticingly low.

When I use allowance figures in a proposal, I explain verbally, and in writing, just exactly what those figures mean and where they come from (see Figure 1). By explaining that I derive my allowance numbers from recent projects similar to theirs, I reinforce the clients’ perception of us as experienced contractors who know our numbers. If the clients are comparing our figures to those of a competitor, our allowances, and the explanations that go with them, reinforce our image of thoroughness and professionalism.

Projected cost basis. When I present an allowance figure, I use my projected cost of the item before markup. This works well for a number of reasons. First, it is the closest I come to open-book job management with our clients. By basing an allowance on the projected cost, I can send a client to a vendor to select a finish floor, for example, and then show that client our invoice or quote from the vendor to verify the actual cost. This approach also eliminates the awkward confusion that invariably occurs when a vendor doesn’t know whether to give the client “retail” pricing or “contractor” pricing. I simply

call ahead to our vendors to let them know that our client will be coming into their showroom to select a product. I give the vendor a quick overview of the project and the level of quality we are looking for. I also tell the vendor whether or not to include labor in the quote. I then authorize the vendor to quote our contractor’s price directly to the client.

Of course, all of this works best if you have a realistic allowance number to begin with. Keep track, not only of unit costs of items that are in the allowance, but also of specific site factors that might affect costs on each job. In my experience, it is much less risky to estimate allowances on the high side than it is to show a low number. In my written allowance explanation, I tell the clients that if the actual cost for the allowance items comes in for less than the allowance listed, 100% of the savings belongs to them. If, on the other hand, they go over, they will



A Word to Our Clients About Allowances

Many of the items on your budget proposal are listed as “allowance” items. (These are indicated by an “AL” under the unit code.) This means that a certain dollar figure has been set as an allowance for each of these items. Generally, we use allowances for work that is commonly sub-contracted such as excavation, concrete, heating, plumbing, electrical, cabinets, appliances, flooring, and painting. These allowance figures are based on current figures from our job files and are intended to represent a realistic and reasonable dollar figure for the item. By including allowance figures in your budget proposal, we can produce a complete budget for you which includes all the anticipated sub-contract items. These figures are then “fine-tuned”, either before or after contract signing, by getting sub-contractors to review the work plan on site. The subs will then provide us with a fixed price for the work item. This fixed price is then reconciled with the budget estimate figure.

The price shown on the proposal represents what we expect our cost of the item to be. If actual costs of the allowance items are less than the allowance price listed, the client is entitled to 100% of the difference between the allowance price listed and the actual cost of the item. If the client chooses options that total more than the allowance figure listed, the client will pay contractor’s cost for the item plus 20%. All such adjustments will be handled as change orders to the contract.

Figure 1. The author’s company routinely uses a variety of handout literature to keep its customers informed, and to address the most commonly asked questions about the client-builder relationship. Because an allowance is not necessarily a self-explanatory line-item, Prime Construction provides a prepared clarification of this budget proposal detail.

pay us the difference plus a reasonable markup. This approach helps foster a team approach, but it also lets them know that they are, at least in part, responsible for any cost overruns.

Preserving Profit

I don't believe in producing proposals with line item costs for every work item. Many contractors do this in the belief that they are fostering trust with the client, but more often than not this practice invites the kind of negotiation that is detrimental to the project and to the bottom line. My estimating software applies a markup to every item on the estimate, but the real bottom line is how much profit the project as a whole will generate. Herein lies the key to protecting your profit when using allowances. If I give a credit based on an unused portion of an allowance, I am giving that credit based on the projected cost, not the marked up price. In other words, I give a credit for the unused goods or service that the allowance was based on, but I do not give back any of the markup or profit on the item. The markup is how we get paid for helping our clients make informed choices, tracking those choices, and administering any changes.

Details count. In your list and in the explanation of allowances, be sure to indicate whether the allowance includes material only, installation only, or both. For example, if you show a \$1,200 allowance for a ceramic tile floor, indicate what that allowance includes. Tile only, or tile, mastic, grout, and labor? In most cases I also try to tie the allowances to specific quantities. Beware of bundling too much work under one allowance. Using our tile floor example, it is fine to offer an allowance based on

Figure 2. When a cost in the allowance exceeds the projected amount, the author issues a change order for the difference that includes an appropriate additional markup for that item to cover the administrative costs. Should the item come in lower than projected, the author writes a change order, refunding only the difference in item-cost, since the administrative charge for the item doesn't change.

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CHANGE ORDER

Number _____

PHONE	DATE
JOB NAME/LOCATION	
JOB NUMBER	JOB PHONE
EXISTING CONTRACT NO.	DATE OF EXISTING CONTRACT

We hereby agree to make the change(s) specified below:

NOTE: This Change Order becomes part of and in conformance with the existing contract.

WE AGREE hereby to make the change(s) specified above at this price ☐		\$	
DATE	PREVIOUS CONTRACT AMOUNT	\$	
AUTHORIZING SIGNATURE (CONTRACTOR)	REVISED CONTRACT TOTAL	\$	

ACCEPTED — The above prices and specifications of this Change Order are satisfactory and are hereby accepted. All work to be performed under same terms and conditions as specified in original contract unless otherwise stipulated.

Date of acceptance _____

Signature _____ (OWNER)

the installed cost of the finished product, but it is best to leave demo and prep out of the allowance figure. This breaks each allowance item into a small package of products and services that is easy to document and reconcile.

Using Allowances for Subs

The judicious use of allowances also has other advantages for contractor, client, and subs. In the current business climate, we're finding it increasingly difficult to get even our most loyal subs to come out and quote a prospective job in a timely manner. For over a year, I've been using allowances for such things as excavation, concrete, electri-

cal, plumbing, and painting. How you apply this in your business will depend on how detailed you get with your estimates. We tend to use the same subs for all of our work, so I have a good handle on their charges. In our company, using allowance figures for subcontracted work has allowed us to produce proposals more quickly and efficiently, and it has saved our subs lots of time. It has also allowed clients to get a good handle on their project budgets without an excessive number of meetings and visits (Figure 2).



Tom Peterson is the vice president of Prime Construction in Burlington, Vt.