

Three Perspectives on Getting Change Orders Right

Change orders are one of the business processes that many builders and remodelers feel most uncertain about. Part of the reason might be that we want to do right by the client and have already started to have a good working relationship with them, so we may be reluctant to rock that boat. So many clients these days are poised to be critical of contractors, having heard from friends or family members that contractors are notorious for low-balling the price and then ratcheting up the cost through changes. Does that matter? It might to the contractor-client relationship, but it probably doesn't matter from a business perspective. A change is a change, and if that change originated with the client, you deserve to be paid for it.

Here are three perspectives from leading building-business advisors Leslie Shiner and Melanie Hodgdon, Tim Faller, and Judith Miller that might help you think a little differently about change orders and help you create a straightforward system that can be integrated easily into your existing business systems.

Create an easy-to-use additional work authorization (AWA) form that your crew can use in the field. It doesn't need to be a complicated form. It should include the date and name of the job, a description of the situation and possible solution, and a place for employee and client signatures.

FORM IS FUNCTION

Leslie Shiner, owner of The Shiner Group, and Melanie Hodgdon, president of Business Systems Management, are co-authors of A Simple Guide to Turning a Profit as a Contractor and provide management consulting for contractors. They emphasize the importance of having a



change-order form that gets things down in writing and moves the relevant details along to the correct party.

A poor change-order process is one of the biggest sources of lost profits for contractors, and it can also be a source of misunderstanding and resentment on the part of customers.

To clients, moving a window 3 inches to the left or choosing a different tile color after the tile has been ordered doesn't seem like a big deal. But these kinds of changes can wreak havoc on your job schedule and can cost significant time.

Have a change-order policy clearly written in the contract and go over that section orally with your customers before they sign. Include in your sales documentation a sample change-order form. Preparing clients for the possibility (and probability) of change orders goes a long way toward getting approval for increases in the contract price as well as maintaining client satisfaction.

Watch the field employee-customer relationship. Perhaps the crew does small favors without proper authorization or notification. These favors may not produce additional materials costs, but they can easily put you over your budgeted hours. Make it clear to the crew that they work for the company not for the customer. Provide production workers with the scope of work and an hours budget so they can distinguish between tasks that are and aren't included in the contract price.

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such as a description of the situation and possible solution, and a place for employee and client signatures.

The form need not include pricing; that can be done in the office. Make copies for client, field, and office. Be sure to include a sentence that says something like “An additional work authorization can and usually does increase the time and cost for the contract.”

A scripted conversation during the initial client meeting about change-order management includes a discussion of the three types of change orders—client modifications to the original scope of work, required code upgrades, and unforeseen circumstances—plus projections (based on historical data) of how change orders might affect the final cost.

CHANGE-ORDER KING

Judith Miller, a Seattle-based construction business consultant and trainer, and a facilitator for Remodelers Advantage, shares a system used successfully by one of her clients.

I often run into questions about change orders with the clients I advise. They don't have a change-order process and that sparks scenarios that stress the client-contractor relationship. It usually begins with a client phone call that goes something like this: “You're nearly 30% over our original budget. What are you going to do about it?”

In some companies, a call like that would set off a string of events, beginning with the client refusing to pay future invoices and possibly leading to the ultimate calamity, a lawsuit. Both sides lose.

What can you do to avoid this? A company I recently visited with has a solution dubbed the “Change Order King.” This is not a person but rather a system for managing the inevitable changes to the scope of work that each change involves. The Change Order King works every time it is fully implemented.

The system consists of the following:

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fications to the original scope of work; required code upgrades; and unforeseen circumstances—as well as projections (based on historical data) of how change orders might affect the final cost.

■ **A clear scope of work** is created along with a final estimate with all owner selections made (no allowances).

■ **A contract** reiterates the definitions of the three types of change orders and spells out exactly how each will be handled.

■ **A checklist** is used for writing up change orders, securing client signatures (written approvals are required), and accepting payment in advance.

■ **Contract billings** reflect total changes to the contract by each of the three change-order types, as well as a revised contract price.

The company rarely had to fall back on this documentation, but when it did, the system came in handy.

In the case of a call similar to the one mentioned above, the company owners spent a couple of hours pulling together copies of all the signed change orders and totaling them by type, then personally presented the reconciliation to the client at the end of the same day. After reviewing the documentation and talking with the company owner about her decisions to modify the original scope, the client said, “You're right, this makes sense. Now I can see where the money has gone. Let's keep going.”

This is a true story. If it's not your story, set up the Change Order King and take control of change orders. You'll be glad you did.

CHANGE ORDERS IN CONTEXT

Tim Faller, a senior consultant and the “Master of Production” for Remodelers Advantage, points out positive and negative aspects of a change-order system that you will want to consider when you are setting one up. In addition, he highlights the importance of putting a price on the disruption caused by change orders.



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Dealing with change orders requires putting a system in place that will prevent you from losing money on additional work. It may help to push some of the responsibility to the field manager by asking him to estimate the additional work and present the change order to the client. Here are some pros and cons to consider with this option.

Pros

The positives of implementing a formal change-order system are obvious, but have some nuance.

Capturing payment. Often the small changes on a job aren't captured because field staff complete the work without a paper trail and estimate just to keep the process flowing. If you encourage your field manager to stop for an hour to write up a change and have the client sign it, you're more likely to get paid for both small and large changes.

Smoother work flow. At any given time, office personnel are working to get more jobs into production. Rather than have them stop and focus on an existing job, the production team can complete the changes. This prevents a log jam in the flow and the production manager or salesperson can concentrate on new sales.

Accuracy. On-site field managers and lead carpenters are more familiar with the full circumstances of the change order and all the phases of the project the change will affect. Ultimately, they are the right people to set it in action, but, as noted below, it may take some training before they are the right ones to price it.

Cons

Setting up a change-order system does have some negative aspects that you should keep in mind.

Sales slack. If the sales and design teams know that the field will handle change orders, they may slack off on preparing a job for production. A "complete package" still needs to be delivered to production.

Increased paperwork. Most lead carpenters are more interested in the work and don't always appreciate more paperwork. It could take their time and attention away from the main job.

Inaccuracy. Despite "accuracy" listed in the pros column, the flip side is that if not trained properly, lead carpenters might be too optimistic for the estimated time it will take for them to complete the change.

An important part of any system you put in place is making sure your team understands it and has the guidance they need for setting prices or for asking for help. If they don't have the expertise, don't give them the reins for the full change-order document. Just have them to fill out an AWA form like the one Leslie and Melanie mention above, and put the price-setting part on the staff—but share those prices with the lead carpenter so he or she begins to develop the understanding to set prices on changes in the future.

Disruption Days

Putting control in the hands of the field manager provides a path

to a basic system. But often the problem is convincing yourself it's worth doing. Consider this: The impact of not implementing a change-order system goes beyond just the money lost on what it takes to add the change to the existing scope of work. What's often missing in the calculation of the total loss is the cost of what I call "Disruption Days." These are the days not associated with any labor costs but that hit the job because of disruption created by the change order. This is especially critical in the current moment—everyone is busy and we can't just reschedule trades or material deliveries for the lost time of the labor. The job could slow down by a week or more for one day of changes.

Try thinking in terms of overhead per day, per job. If overhead in a company is \$500,000 in real dollars for the year with four jobs going at a time, then overhead per day per job is \$500.

That means for every day of a job, you're spending \$500 of overhead. When you calculate a change-order price, the days included in the labor numbers have an overhead amount attached to them automatically, but the Disruption Days do not.

To add insult to injury, by extending the job extra days not associated with labor costs and revenue, you end up pushing the start of other projects out and losing the "opportunity profit" of another job. So some consideration must be given to adding this extra overhead into the sale price of a change order.

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As an example, let's use that same company. It projects \$2 million in revenue for the year, making the overhead 25% of revenue. Assume there are 250 working days in the year, which means the company needs to produce \$8,000 per day to hit the revenue target. If a few jobs extend past the completion dates, and the company does not compensate for the extension by marking up labor, the company won't be able to produce the desired \$2 million. Assume this happens to the tune of 30 days'—or \$240,000 (8,000 x 30)—worth of work that can't be produced. That leaves the company at \$1,760,000 for the year, short of its goal. The 28.4% overhead is robbing net profit of roughly 3.4%.

Some of you are thinking, "I can't just add \$500-per-day extra to every change order!" You're probably right. But the costs are real. So to avoid losing money, calculate overhead per day per job. Write down on each change order the number of Disruption Days. See if you can add that money back in. If you can't add it all in, add something for those lost days. And if nothing else, you'll be aware of what each change really costs you.