

Opinion

LUMP SUM CONTRACTS.

Advantages and Disadvantages.

All construction contracts address critical aspects of a project, including its scope of work, price and payment terms, schedule and an explanation of each party's rights and responsibilities. However, lump sum contracts have specific criteria that can be both a benefit and a hindrance to a construction project.

Under a lump sum contract, also known as a stipulated sum contract, the project owner provides explicit specifications for the work, and the contractor provides a fixed price for the project. These contracts require the owner to complete the project's plans, designs, specifications and schedule before the contractor can establish a price. The contractor then estimates the costs of materials, tools, labor and indirect costs such as overhead and profit margin and provides a quote.

If the project's final costs are lower than the contractor's estimate, then their profit increases. If the estimate is too low, the contractor's bottom line suffers. However, the project owner's finances are unaffected in either scenario.

To modify a lump-sum contract, project owners must submit a change order document that the contractor must approve along with any price changes. That makes lump-sum contracts somewhat inflexible, but they provide a reliable price for owners and reliable revenue for contractors, making them one of the most popular types of construction agreements.

Advantages of Lump Sum Contracts

Advantages for project owners

The predictability of lump sum contracts is the primary benefit to project owners. The owner can expect the project to be completed within budget and often more quickly so that the contractor can maximize resources and save on labor costs. Lump sum contracts also render little financial risk for owners as the contractor is responsible for any cost overruns. These factors make it easier for project owners to obtain financing since lenders prefer to fund defined projects with clearly delineated costs.

Owner supervision of lump-sum contracts is minimal as the owner does not need to track costs. Also, the payment structure of lump sum contracts usually comprises regular payments at specific iterations or as a percentage of the work that has been completed, simplifying accounts payable processes.

Advantages for contractors

Despite the increased financial risk of lump sum contracts compared to some other types of agreements, contractors still receive many benefits.

Under a lump sum agreement, project owners must provide contractors with finalized plans and thorough documentation, resulting in specific, linear project tasks. Lump sum contracts also require less paperwork, management and accounting, decreasing administrative costs.

Another advantage of lump sum contracts is that they do not require contractors to disclose how they calculated their materials or labor costs, allowing them to provide estimates with sufficient cushion to avoid going over budget. If the project is under budget, the contractor keeps the profit.

Disadvantages of Lump Sum Contracts

Disadvantages for project owners

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Owners must submit and adhere to completed designs and finalized plans, making the project inflexible. If a change is needed, lump sum contracts stipulate the use of a formal change order process and a considerable amount of paperwork.

There is also the risk of being charged a higher amount to cover the contractor costs for unforeseen situations. Similarly, contractors could use inferior materials or otherwise cut costs to increase their profit from the fixed price. That's why it's prudent for owners to specify materials in the pre-construction documentation they provide to the contractor.

Disadvantages for contractors

Contractors incur the cost of going over budget, which can eat into profits. Contractors also share the disadvantage of time-consuming change order paperwork if modifications need to occur.