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BI ECONOMICS 02

What Happens When Change Orders Fund the Margin

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Some contractors don't make enough money on the original job.

They make it on the change orders.

The base contract gets priced tightly to win the work. The project begins with little room for error. Then added scope, design changes, delays, and field conditions create the margin the original estimate didn't provide.

A legitimate change order should protect the contractor from work that wasn't included in the contract.

> *It shouldn't be the profit plan.*

When change orders have to fund the margin, the company is depending on events it can't control to make the job work.

The Base Job Should Stand on Its Own

Every project begins with a financial promise.

The estimate says the company can complete the agreed scope for a certain cost and earn an acceptable return.

That promise should hold before a single change order is approved.

Suppose a contractor signs a $1 million contract with an expected gross margin of 20%. The estimate allows $800,000 for labor, materials, trade partners, equipment, and other job costs. The remaining $200,000 must cover overhead and profit.

If the original scope is actually headed toward $900,000 in cost, the job has a problem.

The contractor may recover some of that loss through change orders. But that doesn't mean the original estimate was sound.

> *It means new work is hiding the poor performance of the original work.*

Change Orders Can Hide the Real Job

A growing contract value can make a troubled project look healthy.

The original contract may have weak margin, labor overruns, missed scope, or poor production. Approved changes add revenue and dollars of gross profit. The combined report starts to look acceptable.

But two different things are happening:

1. The company is losing money on the work it originally promised.
2. The company is earning money on additional work.

Combining them can hide the first problem.

A project may finish at its overall margin target while the base contract badly underperforms. Management sees a successful job. The estimator never receives useful feedback. The same work gets priced the same way again.

The company hasn't fixed the problem.

> *It has covered it.*

The Margin May Not Be as Strong as It Looks

Change orders often appear more profitable than base work.

Some deserve a higher markup. They interrupt the schedule, require quick decisions, create added coordination, and may carry more risk.

But the reported margin can be misleading if the company doesn't capture the full cost.

A change order may require:

- Estimating time
- Project-management time
- Superintendent attention
- Revised drawings
- Additional mobilization
- Schedule changes
- Disrupted production
- Extended supervision
- Added insurance or bonding costs
- More billing and collection work
- Rework caused by changed direction

If those costs stay in the base job or in overhead, the change order looks more profitable than it really was.

> *The company may believe change work produced the margin when it only moved costs somewhere else.*

Cash Gets Caught Between the Work and the Approval

Change-order profit isn't useful if the company has to finance it for months.

The work often begins before the price is fully approved. Labor, materials, equipment, and trade partners must still be paid. The contractor carries the cost while the paperwork moves between the owner, designer, lender, and other decision-makers.

That creates a dangerous gap:

- The work is complete.
- The cost has been paid.
- The change hasn't been approved.
- The invoice can't be submitted.
- The profit exists only in the contractor's forecast.

A company can show a profitable project and still run short of cash.

> *The more the job depends on unresolved change orders, the less reliable its reported margin becomes.*

The Wrong Behavior Starts to Look Normal

When change orders regularly rescue weak jobs, the company may start accepting bad habits.

Estimators bid too tightly because field changes usually appear.

Project teams begin work before scope and price are settled.

Owners accept unclear drawings because they expect to recover the difference later.

Managers count unsigned changes as likely revenue.

Nobody wants to confront poor base-contract performance because the final job margin may still work out.

The company stops treating change orders as exceptions.

They become part of the business model.

> *That puts the contractor's profit in the hands of customers, architects, and other people who may dispute the scope, reject the price, or delay approval.*

Separate the Base Job From the Changes

A contractor should be able to answer two questions:

1. How is the original contract performing?
2. How are the change orders performing?

Don't look only at the combined result.

Track the base contract against its original estimate. Keep approved and pending changes separate. Assign the added cost to the change that caused it. Include the management, schedule, and field impact when those costs are real.

At a minimum, review:

- Original contract value
- Original estimated cost
- Current base-contract cost forecast
- Approved change-order revenue
- Approved change-order cost
- Pending change-order revenue and cost
- Unpriced change work
- Amount billed
- Amount collected
- Margin with and without changes

This shows whether the project is producing its planned return or depending on added work to recover it.

Ask Why the Change Occurred

Not every change order reflects a problem.

Owners change their minds. Existing conditions differ from available information. Designers revise the documents. Customers add scope.

Those are legitimate changes.

Other changes begin inside the contractor's own operation:

- Scope was missed during estimating.
- A proposal was unclear.
- A trade partner's work wasn't carried.
- The team started without written approval.
- Rework was presented as added scope.
- The schedule impact wasn't recognized early.
- A foreseeable condition wasn't investigated.

Calling these items change orders doesn't make them profitable.

Review the source of each change. Separate customer-driven additions from estimating misses, coordination failures, and avoidable rework.

> *The goal isn't to eliminate change orders. It's to understand what's creating them.*

Set Rules Before the Project Begins

A few controls can keep change work from becoming a margin strategy:

- Define the original scope clearly.
- Record exclusions and assumptions.
- Set approval limits for field direction.
- Price changes before work begins whenever possible.
- Record time and cost separately for each change.
- Include schedule and supervision impacts.
- Keep pending changes out of committed revenue.
- Review aging unsigned changes every week.
- Escalate disputed changes before the cost grows.
- Compare base-contract performance with total project performance.

The rule should be simple:

> *Don't spend money on changed work without knowing who authorized it, how it will be priced, and when it can be billed.*

Emergencies will create exceptions. Exceptions shouldn't become the normal process.

Protect the Margin You Originally Sold

Change orders are a necessary part of construction.

Handled well, they protect the contractor, keep the customer informed, and provide fair payment for additional work and risk.

But they shouldn't rescue an underpriced contract, hide poor production, or create the appearance of a healthy job.

The original work should earn the margin it was priced to earn.

> *Change orders should pay for change.*

If the company needs them to make the job profitable, the real problem started before the change did.