Types of Contracts

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There are two different types of contract which you may sign with the customer. Your profit and loss ratio will be determined by the type of contract.

Types of Contracts

- Cost Plus Contract
- Fixed Price Contract

Types of contract

- A cost plus and a fixed price contract are two types of construction/development contracts.
- Both are used frequently when entering into an agreement to build a product.
- Each has its own special advantages and disadvantages for both the contractor and the buyer.
- For the construction contractor, the choice depends upon the situation, the needs of the buyer and the risk inherent in the construction.

Fixed Price Contract

- A **fixed-price**, or a **lump-sum contract**, is one where the contractor furnishes all of the labor and provides all of the materials for a certain cost.
- In the event that the contractor's estimates are incorrect or unforeseen costs cause the contractor to spend more to complete the project, those costs are absorbed by the contractor and not passed on to the customer.

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- A fixed-price contract requires the contractor to be careful while bidding for the job due to the potential exposure that may result from an inaccurate bid.
- Alternatively, if the contractor is able to complete the project for significantly less than the stated sum of the contract, then the contractor receives the benefit and the profit associated with the cost savings.

Cost plus contract

- A **cost plus contract** means that the price of construction is the costs plus an additional fee, normally designated as profit.
- The fixed costs include the cost of the materials and labor along with indirect costs known as overhead.
- It is simply an agreement to pay costs plus profit, all as defined in the contract.
- For example, a demolition company may quote $30,000.00 to demolish a lot.

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- During the course of demolition, the contractor discovers that some of the fixtures on the lot extend beneath the surface of the lot such that additional equipment is required to fully remove the fixtures or address the quality of previous construction.
- The $30,000.00 quote will escalate by the additional cost to secure the equipment as well as the cost of any additional labor that may be required to address the unforeseen issues associated with a complete removal of the fixtures.
- A cost plus contract requires less accuracy during the bidding process, given that the contractor knows that any unforeseen expenses will be passed through to the customer.

Pros and Cons -I

- For the contractor, the cost plus contract provides the advantage of a guaranteed profit. The contractor will receive reimbursement for all costs and still make a profit. Under a fixed price contract, there is the risk that the costs will be greater than the price and thus the contractor will take a loss.

Pros and Cons -II

- For the buyer, the cost plus contract offers a better product since the contractor has no incentive to cut costs on lower end materials. In addition, there is no inflation of costs like sometimes occurs in fixed price contracts where the contractor overestimates costs in order to protect against the costs eating up all the profit.

Pros and Cons -III

- The main disadvantage to the cost plus contract is the potential for disputes over what items are costs and how those costs are calculated. It is very important to have a comprehensive contract that covers all of the contingencies and defines in great and clear detail what is and is not cost and how to calculate indirect costs. A well thought out document can make life pleasant for both sides.

Pros and Cons -IV

- The buyer's main problem with a cost plus contract is the uncertainty of the final cost. The way to avoid a price that exceeds budget is to insert a clause in the contract that maximizes the total cost plus feature of the project, thus protecting the buyer from a surprise at the end of construction. Again good planning at the outset avoids disputes later.