HPM AUDIT & CONTRACT SERVICES

Newsletter Library

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CONSTRUCTION AUDIT & ADVISORY SERVICES Newsletter

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IN THIS ISSUE

Is It Simple to Make It Simple?

There is almost nothing about a construction project that is simple. Even when we focus just on the GMP construction contract reimbursable cost terms and the pay application process, the complexity may seem overwhelming. In this newsletter, we are going to discuss the issue of complexity and the typical human reaction to this complexity.

It might be good to start the discussion of construction contract complexity with an understanding of what complexity means, and the concept of subjectivity. Most of us agree that complexity often is used to describe something that is intricate and complicated. Our nature is to try to make the complicated, simpler. In GMP construction contracts, few Cost to be Reimbursed items seem more complex than labor cost and labor burden. An individual's pay is not uniform, even in a Union environment, there are dozens of base pay possibilities, and when payroll taxes, individual benefit elections, and payroll related insurances are included, each person's effective hourly labor cost could be hundreds of possibilities. What is the most common knee jerk reaction to such complexity? If you said, "Agree to a fixed hourly labor rate!", you have a lot of company.

At this point in the discussion, it might be helpful to discuss the parties to a construction contract and their possible different perspectives. Of course, there is the Owner (which we often represent) and the Contractor/ Construction Manager. In the labor cost situation above, The Owner is impacted by the complexity in reviewing the cost support in pay applications. The CM is also impacted, if a fixed labor rate is used, by having to convert its cost-based system, to a unit price system, for billing purposes. Yes, we are saying that to make an Owners billing reviews easier, the Owner has increased the work for the CM. Don't misunderstand, labor costing is complex. A CM employs hundreds, even thousands of employees. Each wants to get paid the correct amount every week, and most, directly into their individual bank accounts. The government wants their share also every week, for payroll taxes, that are subject to each individuals accumulated pay to the point in the year. A Union wants payment for benefits that vary per person, or, in other cases, a health insurance vendor wants premiums paid monthly, for each employee's individual elections. Almost nothing we do as employers is more complex than simply processing payroll every week, and yet CM's employ smart people, with smart technology and systems, to solve this problem and it is essentially done correctly every time. A complex problem has been made simple because of technology and processes and yet, as Owners, we think we need something better. As we contemplate this issue perhaps, we also should ask if the Owners' apparent need to have a simpler pay review process has other unintended consequences.

Consider, if you will (in a Rod Serling voice), subjectivity. Subjectivity exists everywhere like, forgive me my color blind colleagues, "Green, what color green?" If you are interviewing a new hire, "Experience, how experienced, what kind of experience, where was the experience?" Going back to labor cost, how do we determine who we should call a journeyman vs. helper? How about, "Who to call a Project Manager vs. an Assistant PM?" What is the correct number of hours worked in a work week that we should allow a salaried employee to bill? If we decide to agree to fixed hourly labor rates, these are some of the subjective questions that need to be answered, because we have decided to make the pay application review process less complex for us. Of course, none would need to be answered if we allowed the CM to just charge the actual cost paid to the person.

Let's assume we, the Owner, have decided to fix labor rates to an hourly agreed-to sum and let's also ignore that most Owners who consider labor cost too complex may also have a challenge in evaluating a CM's proposal for labor rates. The CM must separately

Should we also ask if whether the Owners apparent need to have a simpler pay review process has other unintended consequences.

from its job cost system, produce schedules of persons names, titles, hours worked, and rates. Mind you, these schedules do not tie to anything in the CM's cost system or payroll system and in some cases don't even tie to an employee's actual pay periods. There is no self-correcting mechanism if too many hours are billed, or an employee's billed title is different from their internal HR title. On this last point, we have one project in the last several months where the billed vs actual employee title overstatement was $750,000 and another, several years ago, where it was over $2,000,000. In both cases, the internal job cost for the CM was correctly accounting for the cost incurred. It was only the Owners election to have a simpler form of labor billing that allowed this error to occur.

Our objective was to give you a different perspective on whether trying to convert complexity and subjectivity into a simple spreadsheet eliminates the complexity and the risk associated with it. Requiring labor billings to conform to fixed hourly labor rates does make the pay application review less complex for most Owners available employees. The flip side cost is that it makes the billings more complex for the CM and decreases the accuracy of the billing, almost always to the Owners detriment, in our experience.

Audit and Advisory Welcomes a New Member

We are excited to announce Laura Tatem joined us in March. We have known Laura for many years through our association with the Association of Airport Internal Auditors where she was the past President. Laura was formerly the VP of Audit for Tampa International Airport, where she developed and oversaw the construction audit department. HPM has a long association with airports and public clients, across the nation, and Laura will be integral to those engagements, going forward. Laura is a Certified Public Accountant, a Certified Internal Auditor, and Certified Government Auditing Professional, among other certifications. She is a graduate of University of North Carolina – Wilmington and she lives in the greater Tampa Bay area, adding Florida to our list of A&A employee residences, which now include alphabetically Alabama, Florida, Georgia, Idaho, Nebraska, Pennsylvania, and Texas.

What Did I Just Sign?

Auditing happens after the fact. Advising happens before. Therefore, our advice, based on seeing the aftereffects, is read all the pages in what you sign. But not just that, only allow statements in an agreement, document, or letter that are specific to the item being agreed to. A common example is where a CM requires an Owner to sign off on using a subcontractor. Too often, however, we see the CM inserting other information into what was supposed to be just an approval to subcontract with Joe's Millwork Company. Information like unit rates, or labor rates for CO's, equipment rental CO rates, or even self-performed work (with extra fee, of course) for the CM. Most Owners hardly even look at these sign offs, even though the CM insists on them being signed. When asked, many say that the forms heading only indicated it was for subcontract approval, not for CO rates. Some Owners think that their contract with the CM should govern anything in a subcontract, and it may, but unfortunately now the Owner insisting that the CO language in the CM agreement overrides the CM's agreement with the sub, just got much more difficult.

AIA Contract Clauses Most Often Ignored and Overlooked

We want you to give us feedback on your top list of AIA Constriction Contract Clauses that are ignored, overlooked, or just not followed. Our top 3 list (the A102 has the same language but different Articles):

AIA A133 Article 10 – Accounting Records – specifically the requirement that the CM will keep full and detailed records related to the Cost of the Work and the accounting and control systems shall be satisfactory to the Owner.

AIA A133 Article 11.2 – Final Payment – specifically the requirement for the CM to submit a final accounting for the Cost of the Work.

AIA A133 Article 11.1.6 – Payments for Construction Phase Services – specifically the "percentage of completion shall be the lesser of (1) the percentage of that portion of the Work that has actually been completed, or (2) the percentage obtained by dividing the expense that has actually been incurred by the share of the GMP allocated to that portion of the Work in the schedule of values.

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IN THIS ISSUE

Lump Sum GC's? Yes, or No?

When contracting for construction, and assuming you are using the GMP CMAR approach, most Owners ask themselves if agreeing to a Lump Sum for General Conditions type cost is the best contracting method. While there is not one answer to all questions related to this approach, there should be a discussion of the pros and cons associated with paying for general conditions type costs as a lump sum.

First, we might want to analyze the reasons we may want to fix an amount for GCs, in the first place. Are these types of costs difficult to review, in that there are lots of small expenses and include some not commonly understood costs like payroll burden and insurances? Are we trying to have a CM bid a low number for these costs and a low bid approach leads us to making these items Lump Sum? Do we believe that these costs, like supervision and management, can be subjective, and we are trying to eliminate the need to evaluate subjectivity?

Secondly, if we are going to specify a fixed amount for GCs, we must define General Conditions. You can imagine that any definition of something we label as "General" is going to take some work and lack of specificity might lead to misunderstanding.

We already stated that there is no one correct answer, so we are not going to attempt to come up with one, but we must point out that the question should not be binary (yes or no). There is a third option, Not to Exceed (NTE). NTE might be a better option in that the sum cannot be higher than, but could be less than the GC amount, and the charges may be reviewed or audited, if needed.

Without writing a dissertation on each of these points, we do want to make just a couple of comments on problems that might arise from the LS GCs method and additional things to consider.

Yes, lots of invoices take time to review and GCs cost have a lot of invoices. However, you do not have to look at every one of them if you do not want to. Some may be more important than others, but having the ability, not the requirement, to look at them may be helpful.

Getting the lowest GCs bid is occasionally good, but having the best CM supervision is almost always good. How many projects that have gone badly, have you complained about the CM having too much supervision or overly qualified personnel? A low bid for GCs (and GCs are at least 60% supervision and management) positively correlates to less supervision and less experienced personnel. Incentivizing less supervision and experience is not our goal, but may be the result, nevertheless.

There can be a case for certain types of GCs costs being subjective. Typically, allowing off-site persons to be reimbursable causes the most misunderstandings. This can be mitigated by making the dividing line clear, between billable and non-billable, in your contract and including that contract in your RFP.

Additional to the possible misaligned goals of Owner and CM with low bid GCs, another result of a LS GCs approach could be a CM shifting certain GCs type costs to the Cost of Work, either in a subcontract or in self- performed work.

Lastly, we all know that what starts as fixed, does not always stay fixed. Having full transparency to actual costs when a claim for additional GCs arises always is helpful.

When we have these discussions (and it is about every other week) we agree with the CM that the Lump Sum is not adjustable, but that does not mean that it is not auditable. Also, just because the CM (at the moment) might think certain costs are not reimbursable, does not mean they are not project related records that are auditable by the Owners accountants.

While there is not one answer to all questions, there should be a discussion of the pros and cons associated with how we are going to pay for general conditions type costs.

You may ask "Why do we care if we are not being charged any more than we agreed to? If they are not going to bill us those costs?" There are many reasons, but some are:

Credits, related to the reimbursable Cost of Work, may be miscoded to the LS or not reimbursable job cost (accidentally, of course), thereby inflating the Cost of Work.

Costs that are to be apportioned to the LS and to the reimbursable cost may only be charged to the reimbursable cost (again, an oversight). Having access to all the cost records would make such errors easy to spot. An example would be dumpsters for demo work versus dumpsters for new construction trash, where demo work is being self-performed on a lump sum basis.

Embarrassing, or illegal, expenditures may be hidden in LS or non-reimbursable jobs costs. Hockey playoff tickets given to the City Building inspector, comes to mind.

As you are contemplating the above, also contemplate that well over 50% of the time, a review of the project records designated by the CM to be LS, indicates that credits are owed to reimbursable Cost of Work, which would have not been discovered except for reviewing all the cost records.

GC Cost Duplication Due to PTO

Truth – Owners like to fix a CM's salaried employees labor rates and CM's love to let them. Unfortunately, while Owners have a propensity for fixing labor rates, many do not audit the cost elements of the rates before fixing them. Occasionally, Owners contracts do not clearly state what costs are included in the rates or sign contracts, with exhibits, which are contradictory.

To backtrack a little, most labor rates we find in contracts are intended to include both base salary and payroll burden. Payroll Burden most commonly consists of payroll taxes, payroll related insurance, like workers compensation, and employee benefits, like health insurance, retirement, and paid time off. Since Paid Time Off (PTO), sometimes referred to as vacation, holidays, and sick time, is an employee benefit and employee benefits are almost always in payroll burden, the fixed labor rates usually include PTO.

If you assume salaried employees average three weeks' vacation, 8 holidays, and 5 sick days, for a total of 28 days, the average employee receives 28 PTO days off out of 260 total workdays, which equals 10.8% of the total. Unfortunately, by grossing up the fixed labor rate to include the PTO, the CM may also bill these same PTO hours directly to the project cost, thereby duplicating the cost.

Some of you may also realize if a fixed labor rate is grossed up to include PTO and a CM uses that rate in its GCs estimate (multiplying all the hours in a year by the fixed rate), the same duplication can occur and inflate the total labor estimate in the Lump Sum GCs by exactly the same 10.8%.

Are you sure that shared savings is a good idea?

We review between 75 and 100 construction contracts a year, with about 40% having a shared savings clause. If you are in the 40%, we would like to discuss what would otherwise appear to be an incentive for the CM to save money, may not be in your best interest.

Captain Obvious here - A CM/Contractor is in the business to make money. Making money means, first and foremost, protecting the contractors fee. If the contractor can protect its fee and complete the project under budget, the dollars associated with being under budget are called savings. A shared savings clause often will allow the CM to participate in a portion of the overall savings. A typical savings amount is 30%. To bring a project under budget, and create savings, that sometimes means working hard and sometimes it means working smart. Unfortunately, our experience is that working hard is hard work, whereas inflating line items in a GMP is not.

If the first obligation of the CM is to protect their fee, then a lot of the heavy lifting, to protect the fee, is done on the front end, in buying out the Work, and scheduling the Work activities. A CM needs no additional incentive in these areas. As work progresses, discretionary expenditures of uncommitted dollars due to judgment calls associated with scope required of subcontractors or schedule changes and directed use of overtime, may have an impact on overall project time and savings. It can be argued that giving a CM incentive to effect overall savings, especially in these discretionary areas, may be beneficial to the Owner, however, because it is so much easier to sand bag the initial estimate of cost, we advise any Owner that believes in a shared savings, to place caps on the overall maximum value of the savings, rather than leave the savings calculation, open ended.

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INSIDE THIS ISSUE

Can We Successfully Weave a Cautionary Tale About Modular Construction and SDI?

Modular construction has been around for centuries. The concept of constructing building components off-site, bringing them to their destination, and installing them in one piece is old news. But despite being an age-old practice, the saying "things get better with time" may not apply here. Many Owners are still optimistic, and some believe it's the magic bullet when it comes to speed of construction and cost. While there are different modular building methods, one of the most common is the production line method. However, as your manufacturing friends know, if there is an issue with parts or labor on the line, the line stops, or you must pull that unit off the line.

Take a recent project we audited. The developer decided to construct a modular build to save time and money on the project. They were smart enough to bake in a long preconstruction schedule to ensure the project's planning was perfect. But that was 2019 and by the time the project was underway, it was 2020, and by then things changed. First, the project had issues getting lumber and other materials needed to complete the units. Next, they could not keep up with the production schedule to meet the project's demands. Units stuck on the line without being completed had to get removed from the line and be completed in the field. That is the total opposite of how modular construction is supposed to go.

The original project had a construction schedule of 10 months to complete. The project all told took 30 months, three times the original estimate.

As a result of not being able to evaluate the true lack of completeness of any specific unit, in this case, the modular company was paid close to $2M more than the extra cost the CM had to pay to other subcontractors to complete the work in the field. Meaning despite back charging the defaulted subcontractor almost $4M, the modular company still had $2M in their pocket for work they did not complete.

Oh, and to make the situation for the Owner worse, the project had an Subcontract Default Insurance policy that the Owner paid for and despite the modular company clearly defaulting on the project, the CM never elected to use the Insurance Policy.

"We charged SDI but we never contemplated using it because the deductible was too high and we knew if we did use it, we would probably never get an SDI policy in the future".

The CM's Project Executive literally said in a meeting, "We never contemplated using the SDI because the deductible was too high and we knew if we did use it, we would probably never get an SDI policy in the future".

If that wasn't enough, the CM and the Modular company were related parties that shared some level of ownership. I am not sure if there could be a worst-case scenario.

At the end of the day, including delays, the cost of the defaulted vendor was close to $7M. A cost that could have been covered by the SDI policy, which, in case I forgot to mention, the Owner paid for.

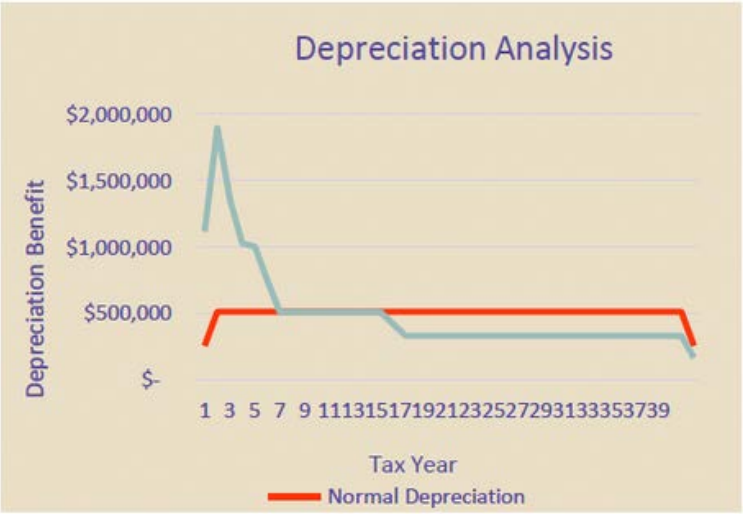
Cost Segregation Benefits, Explained

Any potential tax-paying property owner, either constructing a facility from the ground up, or who has recently acquired or remodeled a property should evaluate performing a Cost Segregation Study. In addition, if you have constructed or purchased a facility in the past 10 years, and have not previously performed a Cost Segregation Study, you can benefit from "Catching Up" on your lost potential.

By properly classifying the asset into real property versus personal property, the IRS allows certain assets to be placed into various accelerated depreciation categories. This permits the taxpayer to move their depreciation forward, in essence getting money today, they would normally have to wait years to obtain.

Cost Segregation is much less an accounting function and much more an engineering and estimating exercise. For this reason, the IRS is beginning to heavily weigh the validity of the Cost Segregation Study by firms that utilize the true engineering approach. While many firms may indicate their studies abide by IRS guidelines, it takes true engineering knowledge of building components to properly segregate the asset correctly. The IRS has stated any study without proper substantiation could potentially be thrown out.

Cost Segregation is now a service provided by HPM, which through a recent acquisition has in-house engineering, estimating, and tax personnel with decades of experience in these studies. Given the information utilized for a Cost Segregation study mirrors the information used as part of the Construction Audit process, HPM is well-positioned to evaluate the potential savings for your project, shown graphically below, for those of you who are more visual.



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Are Claimed Weather Delays an Audit Issue?

As auditors, we are not often asked to evaluate the validity of claims for additional days due to weather. However, your auditor may be able to play a significant role in the review. Let's together understand what the CM's requirements may be to be able to claim an extension of time for weather. Basically, there are typically three main requirements for the CM to make a weather time extension claim. First, they must timely notify the Owner, Second, the weather must be abnormal and therefore not anticipatable, and Third, the impacted work must be on the critical path. While each contract may vary, we are going to take the requirements of the AIA 201 contract as our base example.

Notification - AIA 201, section 15.1.3.1 gives the time frame as to when the request must be given by the CM to the Owner. Claims by either party under Section 15.1.3.1 shall be initiated within 21 days after occurrence of the event giving rise to such Claim or within 21 days after the claimant first recognizes the condition giving rise to the Claim, whichever is later. Per the contract, the Owner is only responsible for claims that were submitted within 21 days of the conditions giving rise to the claim.

Abnormal Weather - We note it is not whether the weather (I'm sorry, but I had to) impacted the Work, it is, if the weather was abnormal. AIA 201 Section 15.1.6.2 - "If adverse weather conditions are the basis for a Claim for additional time, such Claim shall be documented by data substantiating that weather conditions were abnormal for the period of time, could not have been reasonably anticipated…". In this sentence, you may rightfully focus on how to determine if the weather condition s were abnormal, however, you may also focus on the question of the correct "period of time".

Obviously, rain is not the only weather event that impact construction. Snow, wind, and cold, are a few of the more common ones, but using the rain example, the National Oceanic and Atmospheric Administration (NOAA) has details of actual weather from the past. Lacking any other contractual guidance, we have seen the use of a minimum rain per day of .1", to constitute measurable rain. This data from NOAA is easily accessed and can be sorted to include a 10-year average, a 20-year average, or any other combination. You, or even your auditor, can readily see how the actual days compare to the average days. Of course, we would normally assume that the CM should have built the average expected number of measurable rain days into their estimate. While it seems so obvious, we have seen many instances of a CM claiming all rain days as a delay claim, not just those that exceed the average.

The other question is what is the "period of time" that should be analyzed. Is it a week, a month, or some other period? Remember the contract says the weather must be abnormal for the "period of time". Our understanding of this language is the "period of time" must be relevant to the Work being performed. If concrete work is being performed between June and October, then the correct "period of time" to analyze would be between June and October. If June, July, and August were abnormally dry, but September and Oct were abnormally wet, does it make sense that the CM could claim extra delay days when the total, over the entire relevant period, may show that there were fewer rain days than normal?

Critical Path – AIA 201 15.1.6.2 states, "if adverse weather conditions are the basis for a Claim for additional time, such Claim shall be documented by data substantiating that weather conditions were abnormal for the period of time…and had an adverse effect on the scheduled construction." While the analysis of the possible adverse effect of weather on the scheduled construction is a requirement, it may not be necessary to perform such an analysis if the other hurdles have not been met, namely, timely notice and proving the weather was abnormal. While it is not common for your auditor to perform the critical path analysis, or review the analysis given to you by your CM (OK, we can dream), many Owners or

> we have seen instances of a CM claiming all rain days as a delay, not just those that exceed the average.

auditors hesitate to review adverse weather claims at all, just because they feel they are not experts on scheduling. As you can see, scheduling expertise may not even be necessary if there was no notice or if the weather was not abnormal.

On one project this year, the CM had claimed 70 working days for delay due to rain and rain impact. Without any analysis of the critical path schedule, we were able to confirm the days of actual possible rain impact were less than the normal anticipated rain impact, therefore no additional days were due to the CM.

Instead of Contingency, How about Risk Register?

Many of us have had a situation where we are reviewing a GMP estimate with a CM on a negotiated project. Typically, a CM will add a Contingency percentage to the bottom-line estimate, but also estimate specific items per scope of work, which seem to be a lot like Contingency. Sometimes the contractor will call these items Anticipated Cost to Complete or something similar. Basically, they are asking for a Contingency percentage and all the items that a contingency may be used for, in addition.

Previously, we had argued with CM's to remove the specific items, because of the Contingency percentage that was also being applied. Now fairly, sometimes the contracts we were trying to negotiate the GMP on, stipulate a percentage for Contingency, so the challenge was to not allow both. However, it seems a smarter approach may be to allow an establishment of a Risk Register, instead of a percentage contingency.

The Risk Register should be valued at the expected possible cost of the specific additional risk item, but not the total maximum cost of that item. Most of you probably call this the Monte Carlo method. The Risk Register may also contain items that are not as clearly identifiable as others. Risks such as escalation, schedule impact from supply chain issues, design issues, or even estimating accuracy, may be included. Regardless, we think specifying the establishment of a negotiated Risk Register in the contract that contains both known unknowns and unknown unknowns, rather than a percentage for Contingency, is a better approach.

One of the most important aspects of a Risk Registry vs. a percentage contingency is that once the specific risk item has been cleared (possible underground boulder obstructions, for example) the value associated with that risk can be released to the Owner to be used on other project scope. If there was just a percentage contingency, this negotiation for a release of the contingency is much more difficult and less objective.

Are You Segregating Component Costs on Your Capital Projects Based on Different Depreciable Lives?

Most of you have heard the term Cost Seg, or Cost Segregation. Simply put, Cost Seg is the task of segregating the overall cost of a construction project into different depreciable lives, to be able to maximize the current period tax depreciation deduction, thereby, deferring tax on income.

The service itself is easy to describe but it takes expertise in construction estimating, engineering, and tax accounting, to perform the service to gain the maximum customer value.

In Cost Seg, as with all services, there are those that provide some perfunctory work and those that have both the skill and knowledge to completely analyze the plans and specs, walk your project, review contract bids, estimate construction cost, and be able to communicate their knowledge and expertise to anyone who chooses to review their work (you know who). Since it is tax season, our Audit and Contract Services group is uniquely qualified to assist you with this service, if you need it.

Our Audit Team Grows and Welcomes Jake Ortego and Antonio Fratangelo

HPM's industry-leading Audit and Contract Services division has added two new members, Jake Ortego and Antonio Fratangelo. Jake and Antonio had been partners in JA Cost Engineering and currently live in the greater Pittsburg area. Through our past collaboration, we have grown to know them and their capabilities, and are excited to welcome them and their customers to HPM Audit. Jake and Antonio both join our team as division Principals with 20-plus years' of experience in both running complex construction projects and, also, auditing them. Both have an engineering background with Jake having a degree in Mechanical Engineering and Antonio in Civil Engineering.

In addition to construction auditing, Jake and Antonio have provided Cost Control, Cost Estimating, Scheduling, and Cost Seg. services. All of these services complement traditional construction audit. For example, we feel that Cost Control and Cost Auditing go hand in hand, often with no clear dividing line between the two. This additional expertise that Jake and Antonio bring will help better serve our Owners who sometimes need advice on many different interwoven aspects of the construction process.

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What Should a CM's Fee, Be?

One of the most common questions we get asked is "How much should a Construction Manager's fee, be?". While the question is common, unfortunately the answer is not an easy one, but we can give you some basic ideas that may help you decide on an acceptable fee range. First let's define fee with the following elements; Overhead, Risk, Market Demand, Return on Assets, and Profit. All of these elements could and should play a part in a CM deciding on what fee to bid, so we will discuss these below.

Overhead – Since the fee ideally must, at minimum, cover a CM's overhead, any fee percentage collected, in the long term, must be greater than, or equal to, the CM's effective OH percent. Since there is no prescribed definition of Overhead there can be a significant variance in effective OH percentages shown in a CM's financial statements. However, if we adjust OH to only include costs not billed to Owners on projects, the typical range of OH is between 2.00% and 3.5%.

Risk – Risk is the probability that the estimated fee will not be achieved. This risk is lessened by a CM including Contingency dollars in the GMP estimate. Typical negotiated GMP's have little additional risk, not accounted for in estimate of costs or included in contingency, but risk should not be ignored as a potential element.

Market Demand - Market conditions may allow a CM to add to th eir fee or require a subtraction to fee. If resources are scarce a CM may command a fee greater than the sum of OH, Risk, and needed Profit. Likewise, for a short term when demand is less, a CM may not be able to sell a fee equal to OH, Risk, and needed Profit. In most cases, an Owner will have at least a few CM's that are interested in building their project and therefore a market demand fee adjustment is not common. Regardless, in boom or busts, and in remote locations, market demand adjustments must be considered.

Return on Assets – CM's don't have much in the way of capital assets, but they do need a return on key resources, namely key personnel. While it is not common for a CM to consider their quoted fee in this Return on Assets manner, some projects that are either of very short duration or need an exceptional amount of key employee involvement, may dictate an increase or decrease to the Fee because there may be an ability to achieve more or less revenue with the same personnel in a year.

Profit – A CM needs profit to stay in business. Profits allow a CM to maintain a positive cash position, invest in new technology, expand to new markets, offer better employee benefits, and cover risks from market downturns and unprofitable jobs. Most CM's look to achieve between 1.5% and 3% as a bottom - line profit before taxes.

Additionally, just in case you think you now have all of the elements necessary to calculate a fair (fair as in reasonable vs. fair where you go to ride the ponies) fee percentage, you need to evaluate two more key elements. These key elements are whether there is any additional fee enhancers included in the estimated Cost of Work or if Overhead elements can be directly charged. Examples of where fee may be in Cost of Work include; GL insurance rates, SDI or SubGuard rates, CCIP programs, management personnel rates, hourly worker rates, and self-performed work fees. Examples of Overhead items that may be charged directly, include; an allocation of the IT department, record storage, accounting and payroll charges, etc. Obviously, any fee enhancers or overhead allocation allowed as Cost of Work would need to be deducted from your "fair fee" calculation.

Hopefully, once you have considered these elements, you and your CM will arrive at a fee that is fair for both parties.

Therefore, on average, the sub charged $41 more for every hour worked than they actually paid

True Fee vs. Stated Fee

In the previous article, we discussed the various elements and considerations included in a CM fee. It may be helpful to consider this real-life example when evaluating the true ultimate fee.

We recently audited a $40 MM residential project on the east coast. The stated CM fee was 4% but certain otherwise passthrough costs were fixed per the contract. Notably these fixed costs included fee enhancers such as GL and Excess Liability Insurance for the CM at .95%, GL and Excess for subs at 1.75%, and SDI at 1.25%.

Our audit showed that the CM's final cost and fee had exceed the GMP by $650K. This $650K deficit meant that the CM only cleared 2.35% per the contract, however, given the other fee enhancers allowed by the contract, net of real cost, the CM actually cleared an additional 2.5% so the final true fee was 4.85%, .85% greater than the stated 4% fee and even after showing this $650K loss. It may be interesting to note that, prior to our audit, the CM had made a request for a GMP adjustment due to this apparent loss.

True Cost vs. Stated Labor Rates

In the last few months, we were asked to audit a GMP electrical subcontract for a CM and an Owner. The subcontract included an 11% fee and fixed labor rates. The fixed labor rate for a journeyman electrician was agreed to at $78 per hour. This project happened to be in Texas and the subcontractor was a nonunion sub. Based on the subs actual labor cost and payroll burden, the average actual cost per electrician hour was really $37 per hour. Therefore, on average, the sub charged $41 more for every hour worked than they actually paid, before the 11% fee was applied. For this one project, the difference between true cost and contractual cost was $2.1 MM.

One of the lessons to be learned here is that it is important to know what real costs are before you agree to fix any cost element. If you are not sure how to find out, give us a call, we have some ideas.

True Fee vs. Stated Fee

We see at least 6 projects a year where the CM or subcontractor is billing OT, or charging OT on Change Orders, at 1.5% of the fully burdened straight-time craft rates or double time at 2 times the straight-time rate. For those of you that don't see the error in these charges, please consider the following:

A labor rate includes, at minimum, the base wage, payroll taxes, Workers' Compensation insurance, and employee benefits. Employee benefits can either be agreed to in collective bargaining or agreed to between the employer and the employee. In the vast majority of States, W/C is only charged on the base wage, not the premium portion. Likewise, most benefits do not increase in an OT situation. Regardless if the employee is in a union or not, medical insurance stays the same per hour, just as other benefits like vacation and holiday pay. So, while in OT and DT situations the taxable wage is increased either 1.5 or 2 times, the cost of insurance and benefits stays the same. A rule of thumb is that true OT costs are between 1.3 and 1.35 times the base cost. DT, therefore, is between 1.6 and 1.7 base cost.

Be Aware

2021 begins our 33rd year of writing these newsletters. When we have the opportunity to speak at seminars and conferences, we always begin with the message of awareness. You can't change what you don't see, and this is what we hope these mini-case studies will do for you; open your eyes.

In this effort, I usually give a personal example that I hope resonates. I decided to buy a new car a few years ago. I didn't want to have the same car model with the same colors and the same wheels as everyone else, so I carefully picked out a combination that fit my style and was unique. Well, my car came in, and within a week I was seeing my exact same car everywhere. Obviously, those cars were there all along, I had just never noticed. Seeing my car every day allowed me to become fully aware.

Hopefully, this is what these newsletters will do for you, allow you to notice things that are in front of you but have gone unnoticed.

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INSIDE THIS ISSUE

Master Contracts and GMP Amendments — Potential Pitfalls

I am sure it is obvious to you, the more contract pages, contract documents, exhibits, amendments, attachments, and change orders, the more likely it is that one statement from one document may contradict another. Due to these contradictions, the single most difficult part of an auditor's job is trying to make sense out of seemingly conflicting contract statements and provisions.

Let's discuss a situation that we encountered last year. A multinational company entered into a construction agreement with a local California CM firm. While investigating the terms of the construction agreement we found a Master Agreement (signed 15 years ago), seven different Amendments to the Master Agreement, a Scope of Work GMP document for the specific project, and multiple CO's to the GMP. Not much room for confusion around the "deal," right? Before you answer, what if I told you that neither the Owner's Project Manager nor the CM's PM had ever seen the Master Agreement and had only seen the last two Amendments to the Master Agreement? OK, you can answer now.

When we attempted to put Humpty Dumpty back together again, it wasn't surprising that the way the CM had accounted for the project varied significantly from the requirements of the contract. Costs that were supposed to be included in the fee were being billed as cost, labor that was supposed to be billed at cost was being billed at rates, insurance that had a cap was being billed as Cost of Work at amounts much greater than the cap. None of this is surprising, and yet even if your project doesn't have this kind of worst-case scenario, we find similar conflicting contract language on at least 50% of our projects. In many of these cases the people that are running the job from the owner and the CM don't have all the contract documents, or certainly not in one place. Additionally, we see that while the master construction agreement may have been thoroughly reviewed by senior management, lawyers, and consultants, the final GMP amendment may only be reviewed by a few folks that were not involved in the contract negotiations and don't have the experience to recognize that the CM might have intentionally made critical changes to the base agreement. In fact, we had a project just last month where the CM changed the language as to how the fee was to be calculated, what items were included in the lump sum general conditions, and what the agreed to percentage charge would be for a Contractor Controlled Insurance Program (CCIP), in the GMP amendment. On this $55 MM project, these changes made by the CM were not noticed by the Owner in the GMP amendment and, by contract, supersede the contract terms, potentially allowing the CM to bill an additional $750,000 to the Owner.

Therefore, our advice is to make sure you have at your disposal every single contract document. At least once, read them through sequentially, by date signed, so you don't have to rely on your memory. Review any document prepared by the CM that will become a contract document, especially those that take precedence, like amendments, exhibits, and CO's, looking specifically for the possibility of intentional misstatements, wording changes, calculation changes, etc. If you do this, I guarantee that you will be in the top 10% of Owners, as far as deal point knowledge and, you will be better prepared to avoid being taken advantage of, you will catch most contract contradictions, and your humble auditor will thank you.

(continues next page)

The cost of small tools is the subject of urban legend, like its distant cousin, the cost of GL insurance.

Mitigating Subcontractor Default Risk – Do You Really Need Bonding or SDI?

The COVID 19 effect on the bottom line for construction companies and subcontractors is still to be determined, yet it is obvious that delays are increasing costs and some new projects are being postponed or canceled. These facts increase the likelihood that some subcontractors may become financially unstable in the coming year. We need to remind ourselves that our contracts already have some safeguards built into them that we may have taken for granted or didn't feel were necessary, in the past. Specifically, we are referring to retention provisions and reviewing the percent complete billed in interim pay applications.

Most contracts require some hold back of otherwise earned money from contractors and in turn from subcontractors, which is called retainage. Usually, a starting point for negotiation of this retention amount is 10%. Yes, I know that we have relaxed this requirement over the years for different reasons, but now may be the time to reexamine the base 10% level and make retention less than 10% the exception rather than a rule.

While retention is a key risk mitigation tool, being diligent in verifying the Total Completed and Stored on Pay Applications, is primary. As an Owner, we cannot only rely on the CM to perform this task. We, at minimum, need to verify the CM's method of verifying the percent complete or do it ourselves, independently. One key tool, in not overpaying, is making a subcontractor provide an understandable contract schedule of values for pay application purposes. We should verify that this schedule is not "front end loaded," meaning that the tasks that are to be completed first are given a disproportionately high contract value.

Having mentioned the two items above, we need to also emphasize that an Owner should require the CM to perform some level of review as to the subcontractor's financial health and their current job performances. If we follow these obvious steps, then selectively requiring some subs to provide Payment & Performance bonds or, our least preferable and most costly option, having a CM provide SDI, might not be necessary.

What Do Small Tools and Consumables Really Cost?

The cost of small tools and consumables is the stuff of urban legend, like its distant cousin, the cost of GL insurance. Ask anyone that has been around a construction site or has been involved in negotiating construction contracts and change orders and you will hear, most typically, 4% of labor. Sometimes we see quoted 4% small tools and a separate 4% for consumables. If you were inclined to agree to fix a percentage of labor for small tools, let me ask you to consider the following questions first. First, what are you going to assume is a small tool and/or what are you going to assume the cost threshold is for a small tool? Second, when you refer to small tools, are you also intending to include consumables in that definition? If so, which items are you going to call consumables? Lastly, after you decide what is a small tool and a consumable item, do you want to fix a percentage based on fully grossed up labor or some part of fully grossed up labor?

Consider the following as you are answering these questions. Construction tools have not increased in cost significantly over the last 30 years. Hand drills, pallet jacks, porta band saws, and job boxes have stayed mostly flat. On the other hand, wages have not. Base wage for an electrician in Austin is around $30 and base wage for an electrician in San Francisco is around $60. With payroll burden, the Austin gross labor cost is about $40. With union benefits and other payroll burden, the SF gross labor cost is above $100. However, a cordless drill largely costs the same in Texas or California. If you were to pay the electrical contractor 4% of gross wage in either location, the effect in Austin is about an extra $275 per person, per month, and in SF it would be $690 per person, per month. If you tried to outfit your hypothetical electrician with all of the small tools that they would need in a typical day and attempted to put a reasonable expected life on those tools, you would come to an expected cost of no more than $110 per month. Including consumables, like PPE and drill bits, that monthly amount could be as much as $150, which equates to about 3% of base labor in Austin and about 1.5% of base labor in SF. Please take this into consideration as you are negotiating the rate to pay for small tools and consumables.

Mike Byrne Retirement Announcement

My former CCM partner and HPM colleague Mike Byrne is retiring from our day-to-day audit and consulting business. I first met Mike in 1996 when he was a CFO of a construction company in Denver and I was auditing them. I asked him then if he planned on retiring working for a contractor and two years later, he called me and said no. Our first project together was for American Airlines at LAX, and we have been working together now for 22 years. Mike is detailed and thorough, knowledgeable and measured, and his day to day presence will be greatly missed by me.

Great things await in the future, Mike. Thank you for the past!

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INSIDE THIS ISSUE

CONFIRMING the CM WILL PROVIDE an ACCOUNTING SYSTEM GENERATED JOB COST REPORT

I am not sure if it is a trend, but several times in the last year we have had an issue in getting the CM to provide a detailed job cost report, generated by their accounting system. In those cases, these CM's try to give us a "job cost" created in their project management system, which tracks budget and commitments along with change order proposals. Of course, monitoring commitments is not the same as actual amounts paid, especially when many types of costs don't have hard contract commitments, like General Condition costs, as an example.

We have seen these project management system job cost reports vary significantly to actual job cost reports (once we finally obtain them), sometimes including invoices and cost that simply do not exist or not including credits that really do exist. Because these management system reports don't have to tie to costs actually incurred, it is easy to envision a CM intentionally inflating the non-accounting system job cost that they want the Owner to see, with hopes that they don't notice the difference.

ALLOWING SUBCONTRACT DEFAULT INSURANCE, BUT NOT INCLUDING CONTRACT LANGUAGE THAT REQUIRES THE CM TO USE IT

We constantly preach about the possible pitfalls of allowing the CM to use SDI. Again recently, we have had a CM argue that they had to replace a sub (in this case two), that were failing to meet schedule or not properly performing their work, and yet they were not obligated to put the subs into default. Since SDI will only respond if the CM puts the sub in default, the CM argued that all additional sub cost should be paid by the Owner. In this one case, the additional cost was $220,000 which reduced the Owners savings.

In the above case, we are not saying that there was no language in the contract that did not require the CM to act in the Owners best interests, and certainly using the SDI that the Owner had paid the CM for would have been in the Owners interest, but it would be more clear if the Owner (or their legal counsel) had simply stated that any cost incurred by the CM, in excess of a fixed price subcontract, for work specified in that subcontract, would not be reimbursable, regardless if the CM elects to terminate for convenience, or replace for any reason. After all, isn't this why we let the CM charge us for SDI, in the first place?

CONVERTING A GMP SUBCONTRACT TO A LUMP SUM

For many good reasons, we sometimes need to get subs on board well before all the scope documents have been decided and approved. Often, we need some early work to begin, other times we need preconstruction assistance. Regardless, in finally agreeing to a total contract sum, we now have a challenge in making sure we ultimately have gotten a fair, market driven deal. In this situation, we sometimes see an Owner, through a CM, starting off with a GMP subcontract with the end goal of converting the subcontract to a lump sum. Outside the scope of this article is the occasional, seeming, irrational fear of having a GMP subcontractor (which seems to be mostly driven by CM's trying to make their life slightly easier).

The question, of converting an initial GMP to a Lump Sum, is how? So, to try to answer this question, we start with some assumptions:

"it is easy to envision a CM intentionally inflating the non-accounting system job cost that they want the Owner to see, with hopes that they don't notice the difference."

1- You can't have a GMP without an agreement on the definition of reimbursable Cost of Work.

2- You also need an agreement on fee markup (OH&P).

3- You have to have the right to review and audit the subs estimate and support for the estimate, including labor, labor burden, materials, equipment, insurance, tools, labor efficiency units, rental equipment costs, and more.

At this point, most of you are saying to yourself, "this is pretty obvious and what is the point?" The point is that it appears that many CM's don't take the time to understand what they are asking for in their RFP's. They might state what the definitions of Cost of Work are (actual cost of labor), but in another section ask the sub to tell them what their labor rates will be on CO's. Again, the Cost of Work may say actual cost of materials, but in another part of the RFP the CM may ask what Trade Service column the sub intends to price materials from. In these cases, the real deal may be confusing from the outset, with each party having some justification for their view. Regardless, we don't need to tell you that quoted labor rates don't equal cost and subs don't buy from a Trade Service publication.

As an Owner, you have to realize that it is ultimately your money, not the CM's. Many times, after the drawings are completed, we see the CM say that they have reviewed the subs final estimate and have recommended that the estimated amount from the sub, be converted to a lump sum. The obvious question to ask is, "why would an Owner do that without a significant price reduction?"

Recently, we had the occasion to also review a sub estimate that had been recommended to be converted to a LS, and we noted $1.8MM in overstated costs, mostly labor overstatements, but also duplication of costs, unneeded scope, and excessive small tool and consumables. In discussions with the CM, we came to the realization that the CM did not review the real cost of labor, did not question why the sub included insurance in the labor rates (the project was a CCIP that includes W/C and GL), and did not question whether 10% of gross labor for small tools and consumables made sense. In this case, the Owner was able to negotiate a $1.3MM reduction and ultimately elected to convert the GMP to a LS.

DOES LUMP SUM MEAN NOT AUDITABLE?

I don't think I have ever met a CM that believed that the Owner had the right to audit the cost charged to some non-reimbursable job cost account or a portion of the job, set up and agreed, to be charged as a lump sum (i.e. Lump Sum GC's or Self Performed Work). In many GMP contracts, the Owner has the right to inspect and review the project records. Typically, these contracts do not say that the Project records are limited to just certain records that the CM wants to show the Owner's accountants.

When we have these discussions (and it is about every other week) we agree with the CM that the Lump Sum is not adjustable, but that doesn't mean that it is not auditable. Also, just because the CM (at the moment) might think that certain costs are not reimbursable, doesn't mean that they are not project related records that are auditable by the Owner's accountants.

You may ask "Why do we care, as long as we are not being charged any more than we agreed to and if they aren't going to bill us those cost?" There are many reasons, but some are:

Credits, related to the reimbursable Cost of Work, may be miscoded to the LS or not reimbursable job cost (accidentally, of course), thereby inflating the Cost of Work.

Costs that are to be apportioned to the LS and to the reimbursable cost may only be charged to the reimbursable cost (again, an oversight). Having access to all of the cost records would make such errors easy to spot (Dumpsters for demo work vs. dumpsters for new construction trash, where demo work is being self-performed on a lump sum basis).

Cost that are charged to non-reimbursable may point to other errors, like consultants being billed as employees (at fixed labor rates), or rental equipment from third parties being charged as if it were owned by the CM.

Embarrassing, or illegal, expenditures may be hidden in LS or non-reimbursable jobs costs. Hockey playoff tickets given to the City Building inspector, comes to mind.

As you are contemplating the above, also contemplate that well over 50% of the time, a review of the project records designated by the CM to be LS or non-reimbursable, indicates that credits are owed to reimbursable Cost of Work that would have not been discovered except for reviewing ***all*** of the cost records.

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INSIDE THIS ISSUE

SEEMINGLY FAMILIAR CONTRACT TERMINOLOGY

Many of you review a lot of construction contracts. In the course of your career you might have seen hundreds, even thousands of draft agreements. If you are like us, you get used to seeing the same construction terms in the same sections of the contract. You might even begin to glance over parts of the contract that do typically change or look for only the typical additions in the typical places. Unfortunately, you may get a surprise from time to time.

Many years ago, we audited a contract where the Owner had believed that they had agreed to a fixed payroll burden rate of 40%. However, on closer inspection, we told them that they had agreed to a "fixed payroll benefit rate" of 40%. Not included in payroll benefits are W/C insurance and payroll taxes. Our Owners perceived deal of 40% became closer to a chargeable 52% "payroll burden" rate.

Staying with the payroll burden theme, we audited a project in one of our northern states, where the contract stipulated a fixed payroll of 45% of the "employee gross wage". What the Owner did not realize was this GC added the employee's union benefits to their union-mandated wage and then deducted the union benefit, pre-tax. The only reason for this, in and out, was to create a much higher "gross wage" from which to add 45%. What the Owner had assumed was a total 45% payroll burden became a billed 87% payroll burden.

Just a month ago we audited a GC that had gotten the Owner to agree to a fixed 1.5% of enrolled subcontracts for the contractor's "subcontract default program". When we asked to verify which subs were enrolled in the Subcontract Default Insurance, we were told that the GC elected not to buy insurance on this particular project, but all subs were nevertheless enrolled in the GC's "program". The GC's argument was that the Owner agreed to the GC's program and actual insurance was not mandated. I can feel some of you reaching for your contracts right now to see if you agreed to a "program" vs. insurance.

FIXED LABOR RATES AND THE $14.00 P.H. ASST. SUPERINTENDENT

We constantly preach about the possible pitfalls of fixed labor rates. Our sermons are not based on a preference of actual cost versus fixed rates (OK, keeping with the theme, I may be slightly lying about not having a preference) but in making sure you realize that there are potential issues to be aware of, under any approach. So, when you agree to fixing labor rates and specifically rates related to job titles, keep in mind that job titles are subjective. This leads us to an interesting audit we performed recently in LA. Many of you, that are from the South, know that I am talking about Lower Alabama.

The Owner had agreed to fixed labor rates for Project Manager, Asst. Project Manager, Superintendent, and Asst. Superintendent. During the audit we discovered two individuals being charged at the Superintendent rate and one at the Asst. Superintendent rate. Because of the job cost system utilized by the CM/GC we had visibility to the actual employee

When we asked to verify which subs were enrolled in the Subcontract Default Insurance, we were told that the GC elected not to buy insurance on this particular project, but nevertheless all subs were enrolled in the GC's "program".

wage for all classes of employees, other than Project Managers. We noticed that one of the Superintendents made $45 per hour and one made $28 per hour. We also noticed that the Asst. Superintendent made $14 per hour.

Consulting with Indeed.com we determined that GC's in the surrounding area had placed job postings for construction Superintendents paying $75,000 to $90,000 per year ($36 - $43 hourly). We also consulted with the Owners on-site managers and determined that they felt that there was a significant performance difference between the two employees billed as Superintendents. Based on this knowledge and the pay disparity, we reclassified one of the Superintendents to Asst. Superintendent. Additionally, given that the GC had previously defended a subcontractor charging $20 per hour, plus burden on a Change Order, for a laborer, we reclassified the Asst. Superintendent to his actual cost. Overall, these corrections, that only were needed because of having fixed rates, resulted in a $120,000 cost reduction on a little $4 MM job.

SHOULD I REVIEW THE SUB INSTRUCTION TO BIDDERS?

Most of you know you have access to the subcontracts, if you desired to see them. Most of you have seen some version of a sub bid comparison before your CM entered into a subcontract. My concern is that you still don't really know what scope is included in the subs bid price.

We audited a project in CT (Central Texas, I couldn't resist) recently. The CM indicated that they had processed all final CO's to the subs. In the course of reviewing the subs scope exhibit, we noticed that one had an allowance of $12,000 for the "sole use of the Contractor". We looked for more of these allowances and found over $85,000 in allowances, imbedded in the subcontract values, for the sole use of the Contractor. Review of the sub CO's showed not one of these allowances had been reconciled or used. Interestingly, none of the sub bids called out these allowances, but we surmise that the instruction to include these allowances in the bids was included in the subs request for pricing instructions, which amazingly, couldn't be located by the CM. This type of "off the books" contingency/savings/fee enhancement is not uncommon. We had a project several years ago in NYC (New York City) where the hidden allowances came to $875,000.

WE DON'T HAVE A JOB COST REPORT

Do you ever contract with a CM that does many hundreds of millions in revenue and just assume that they have accounting systems in place to control and monitor cost spent? My advice is that you shouldn't take accounting controls for granted. Recently we audited a medium size CM ($450 MM in yearly revenue) that had only a partial job cost system. A partial system where only the net billing from a sub (amount billed less retention) was entered into the CM's accounts payable system and job cost. The CM had to manually calculate what retention was due to each sub and how that compared to the gross amounts billed to the Owner.

We also have heard recently that various CM's had no ability to produce anything other than summary job cost reports (no transaction details), no accounting job cost report (only Prolog project management reports), no job cost report (only a billed cost report), and, not one, not two, not three, but four different reports that must be added together to get to the total cost report.

So, ask the CM to give you sample job costing and monitoring reports, before the project begins. If you have any questions on the reports they provide, you know who to call.

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INSIDE THIS ISSUE

GENERAL CONDITIONS ESTIMATE DUPLICATION DUE TO PTO INCLUDED IN PAYROLL BURDEN

One of the little known, or less considered, facts is that the elements of payroll burden can vary substantially from Contractor to Contractor and even with the same Contractor from job to job. One common element of payroll burden is Paid Time Off (PTO) otherwise referred to as vacation, holidays, and sick time. Whether PTO is included in the Contractors payroll burden can make a big difference in the overall General Conditions estimate and, if it is included, may duplicate the PTO time included in the General Conditions estimate.

To illustrate this point, consider a 12- month project. In this example, we are going to assume that the contractor will be employed for a month's duration of preconstruction effort and will be closing out the project for a month after substantial completion.

Your contractor presents a GC estimate that includes 14 months for a Sr. PM. The estimate includes a payroll burden rate of 45% which the contractor says includes all employee benefits (and we know that PTO is a benefit). We also learn that the contractor had included, in the 45%, an assumption that all salaried employees get three weeks' vacation, 8 holidays, and 5 sick days, for a total of 28 days.

Therefore, the employee receives 28 PTO days off out of 260 total work days equal to 10.8%. You ask the contractor how they intend to bill the Sr. PM's hours and you are assured that only worked hours will be billed, no PTO will be directly included. Initially, you may feel better, but then you may wonder why, if the contractor is only going to bill the worked hours (because the PTO cost is included in the 45% payroll burden rate) and with 10.8% of the total duration hours estimated to be PTO, are hours, that will not be billed, still in the estimate? After all, the estimated man hours for the Sr. PM was 14 full months, not 14 months less 10.8%. Your reason to question the calculation of the estimate is a good one and illustrates the duplication. PTO is included in the payroll burden and the total days for PTO are also included in the estimate of total man hours. Just in the last year, we have been involved with three larger projects where this salaried labor estimate duplication has allowed the Owner to correct the GC's estimate, prior to GMP, by more than $500K on one and more than $1 MM on the other two, for just this one type of duplication.

CONSIDER MAKING GL INSURANCE A PART OF THE FEE

Let us acknowledge that insurance can be a confusing subject and the establishment of the actual cost of insurance can be a challenge. On a traditional project, the contract may require the contractor to purchase and maintain W/C, GL, Excess, Auto, Pollution, and Professional Liability. For these insurances, the contractor may pay its premiums as a function of labor, contract value, or at a fixed amount. Additionally, the contractor may elect to reduce its insurance premium costs by agreeing to be liable for a deductible, which may range from $25,000 to $1,000,000 per claim. The contractor that has a substantial deductible, will always include an internal estimate of the possible deductible cost and risk. The contractor may also want to include, in its insurance calculation, types of insurance that are not required by the contract. Unfortunately, contractors with large deductibles often do not want to share their claim history, to enable us to judge the expected cost of having a large deductible. You may also be interested in knowing that many contractors are

"Because of the confusing and complicated nature of determining the actual cost of insurance, contractors often attempt to fix an overall insurance percentage cost. ***Our experience is that the percentage offered (often between 1.2% and 0.75%) is greatly overstated."***

very creative when calculating their total insurance cost. Contractors often buy their insurance through captive insurance companies, which makes the premiums paid to such contractor owned companies, suspect.

In part, because of the confusing and complicated nature of determining the actual cost of insurance, contractors often attempt to fix an overall insurance percentage cost. Our experience is that the percentage offered (often between 1.2% and 0.75%) is greatly overstated.

I am assuming that this description of the situation we face, on a typical project, may start to get you thinking that there may be a better way. Because of this complexity, our recommendation is that all insurance, other than Workers Comp., be clearly stated, in the RFP and contract, as not being reimbursable. The contractor will, in a competitive environment, be required to include the true amount of this non- reimbursable cost in its fee. A contractor that increases its fee unnecessarily, will find itself at a competitive disadvantage when quoting their bid fee. For Owners that employ this bidding and contracting method, we have regularly witnessed fee increases, to allow for non-
reimbursable insurance, at substantially less than those contractors had previously attempted to bill Owners for the same insurance at fixed rates.

ARE YOU BEING BILLED FOR PEOPLE THAT ARE NOT ON-SITE?

On our projects, contractors and subcontractors employ hundreds and even thousands of workers. Many of the larger projects, including most GMP and IPD contracts, the Owner is billed for many of these workers directly as Cost of Work (as opposed to within lump sum contracts). Shockingly, most Owners don't have actual knowledge of who is on their project site, what days, or how many hours they were there. Clearly, there are security, insurance, and cost ramifications to not being able to verify persons and hours at the project site. Even on lump sum contracts, there is often substantial overtime work that becomes part of an Owner Change Order, so knowing actual OT hours worked, is important.

In the last year, Owners and contractors are beginning to avail themselves of job-based systems that record specific employee's hours spent on the job and can summarize such data, by subcontractor. One client, that has employed one available personnel tracking system, Site Traxx, enabled us to use that data to identify more than $500,000 in overstated labor charges, from one subcontractor, for persons that were either not on site or not on site for the hours billed. On the same project several other subcontractors corrected their monthly billings immediately when they realized that the Owner had this accurate data. Interestingly, most of the subcontractors (and the GC) embraced the ability to know the hours worked by their employees as an independent verification of the employee's time reporting, and to have a true headcount which also benefited scheduling.

SHOULD YOU ALLOW YOUR CONTRACTOR TO PICK THE AUDITOR?

I assume that the idea that the contractor should not be able to dictate the company, or person, that will audit them, is not terribly controversial. However, we do witness those type of contract requirements more often that you may expect. We also occasionally see a contract where the contractor has stated one auditor or audit firm, as being unacceptable.

I do think it is legitimate that a contractor may want assurance that the auditor will be experienced and capable of performing an audit and the contractor may correctly object to an auditor that is compensated based on recovery. Except for these points of clarification, however, we feel that the Owner should be able to hire any company that it desires. Additionally, it is likely that any contractor calling out a single company or auditor, may be doing so, not for legitimate reasons, but to artificially limit the Owner in hiring the best audit representation. To say it another way, the firm or individual, that the contractor does not want to be audited by, may be the best firm for the job. Just saying.

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INSIDE THIS ISSUE

HOW TO ANALYZE THE PROPOSED COST OF AN OCIP OR A CCIP

We have often had a front row seat to an owner's attempt to decide on whether to implement an OCIP or purchase a CCIP. Part of any decision to buy, or not buy, is the evaluation of whether the OCIP/CCIP will save money. This dilemma is exacerbated by the lack of information on the true cost of insurance, within the typical construction contract. After all, it is this typical insurance cost that is going to be supplanted with the proposed OCIP or CCIP.

Before we continue, it is helpful to define our terms—OCIP and CCIP. This standsfor Owner Controlled Insurance Program (OCIP) and Contractor Controlled Insurance Program (CCIP). These programs are almost always separate from Builders Risk insurance, which confusingly can be purchased by either the owner or contractor but are normally not referred to as included in an OCIP or CCIP.

OCIP/CCIPs can be both Workers Compensation (W/C) and General Liability (GL)—Excess Liability programs or GL-Excess Liability only programs. So, OCIP or CCIP, with or without W/C.

With this background, we must realize it's the typical cost of insurance from the construction manager (CM) and the subcontractors that is going to fund the cost of the OCIP/CCIP. This is what we are going to refer to as the "avoided cost". Since most W/C and General Liability insurance policies are paid based on some calculation of actual incurred payroll, or on revenues, when an OCIP/CCIP is implemented the CM's and subcontractor's policy cost is avoided; therefore, there is an opportunity to collect credits equal to those policies' cost to help fund the OCIP/CCIP. It is useful to understand that while most OCIP/CCIPs also include Excess Liability insurance, Excess Liability/Umbrella policies are paid as a lump sum cost, per year, by the CM and subcontractors. Therefore, it is often difficult to negotiate an insurance credit for an "avoided cost" that is otherwise going to be paid regardless of an OCIP/CCIP.

Most OCIPs are written with a fixed known cost and a projection of probable losses, thereby estimating the final cost of the insurance, to which an owner must add any administrative costs and fees to estimate the total cost of an OCIP. Additionally, most CCIPs are quoted from the contractor to the owner at an agreed fixed cost or percentage of contract value. In either case, the expected cost is easier to estimate than the "avoided cost", at least certainly in advance of purchasing the OCIP/CCIP.

It is for this reason that we have seen brokers and CMs selling an owner on an OCIP/CCIP in excess of the expected avoided cost yet professing to the owner a substantial savings. We witnessed, first hand, a national insurance brokerage firm explaining to an owner that W/C and GL/Excess Liability insurance make up 20% of the total construction contract and, therefore, the quoted OCIP, at 4% of contract value, was a huge savings for the owner. We likewise have seen CMs' analysis of subcontractor's true cost of insurance using rates, in some cases, ten times higher than real cost, thereby setting a false expectation of the avoided cost and making their CCIP quote seem reasonable.
As the purchaser of an OCIP/CCIP an owner should require the seller of the OCIP/CCIP to show the calculation of the probable avoided cost, complete with actual credit insurance forms filled out by CMs and subcontractors. If your broker

or CM tells you they can't find the proof or don't have any actual data to back up their claims, then you can be sure that their claim of the expected insurance cost is very suspect.

WHEN SELF-PERFORMED WORK ISN'T SELF PERFORMED AND WHAT IS IT?

We seem to find a CM billing for self-performed work—with an additional fee of course—on 75% of the projects we are on. One significant problem is that there is no universal meaning to the term self-performed work. Too often, a CM will get an owner to agree to allow self-performed work, including a self-performed fee, on work that appears to be normally subcontracted, only to have the CM expand the definition of self-performed to any, and all, labor on the project, including labor for clean-up and miscellaneous safety protection work. Additionally, we sometimes find that the work that the owner agreed to be self-performed is mostly (80%) subcontracted to actual subcontractors.

Our recommendation is that any agreement to allow a separate fee for self-performed work should be limited to actual labor, plus materials installed with that labor, and that any general conditions or general requirements labor be excluded from such extra fee calculations.

HIDDEN PROBLEMS FROM FIXING LABOR RATES

Owners and CMs seem to love to fix labor rates, based on how common such an agreement is in the contracts we audit. We suspect that an owner's motivation to fix labor rates is different than the CM's motivation, yet both arrive at the same solution. So, let's assume that you have fixed a labor rate agreement with your CM. What could possibly go wrong? Well, let me think… how about:

1. Not being clear as to what is, and is not, included in the fixed rate (Employee benefits? Which employee benefits?).

2. Not defining what is meant by a job title and how such titles are to be verified (They looked like an Assistant Project Manager).

3. Converting a salaried person's pay to an hourly rate, without explanation that such rate is predicated on an assumption of 40 hours worked per week and 8 hours per day (Anyone know why we are paying 65 hours per week for the Senior Project Manager?).

4. Paying much more in the fixed rate than real cost (I guess all Project Managers make $200,000 a year).

ORGANIZATIONAL CHANGES

In 2015, most of the CCM team, became part of Hoar Program Management, LLC (HPM). Except for the name change, our audit and client focused consulting work remained the same. *While our work and clients have remained the same, our combination with HPM has afforded us the opportunity to expand our employee base, and we are extremely fortunate to have added three extremely experienced construction auditors to our group—Principal, Ryan Austin and Senior Associates, Valerie Rogers, Scott Jaye and Allan Meyers. Mike Byrne continues to be a significant part of our HPM Audit and Contract Services group through our continued association with CCM Consulting Group.* ***For more information about our services, and to view our archive of newsletters published since 1998, visit the Audit & Contract Services page on the HPM website at www.hpmleadership.com/service/audit-contract-services/***

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WHAT DO BONDS COST? ASK YOUR CM.

We had the opportunity to participate in a CM selection for a major corporate headquarters project. As part of the CM interviews we asked each of the four CM firms to estimate the cost of subcontractor bonds. Three of the four had SubGuard or SDI programs, while one did not. The estimate of the average cost of sub bonds on this $300 M plus project from the three SubGuard companies ranged from 2% to 1.5% of subcontract value. The only company not hoping to sell SubGuard estimated a cost of less than 1%. We have experienced this same bias when asking a CM of their opinion of market costs for sub CO fees, the cost of labor, and with insurance brokers selling OCIP's. Obviously, the lesson is to not rely on the candid advice of a CM, when they may have a reason to inflate their estimate. This is especially the case when they do not overtly disclose their potential conflict of interest.

SUBCONTRACTOR PROCUREMENT STRATEGY

GC's and CM's will usually prepare bid packages and a RFP to be sent to prospective sub-bidders for selected scopes of work. These RFP's will typically ask for a fixed price for performing the work. These RFP's also will often ask for additional information from the bidders, such as corporate financial and safety-related information. Sometimes, and much too often, the CM will ask the subs to quote the fees that they want on CO's or ask the subs for their labor rates to be used on CO's. This later type of information is almost never used in the selection process but is nevertheless inserted into the subcontracts as a unit cost to be used if CO's occur.

Most Owner contracts contain language as to how CO's are to be priced. Labor, material, and equipment costs of a Change is assumed to be at Cost, unless there is an agreement in the Owner/CM contract to price those items differently. When the CM inserts language into its subcontracts, that fix certain cost at a predetermined amount, this causes a conflict between the CM agreement with the Owner and the contract with the sub. The CM often is attempting to fix labor rates because it makes it easier for them. Usually, there is no regard to whether these quoted costs are accurate. In fact it is very common that the amounts allowed to a sub for a common wage classification like Carpenter is much greater than the Owner allows the CM to charge for the same classification, given that the CM is limited to only charging actual cost.
To further illustrate this point, we recently reviewed a CM selection for a union electrical subcontractor. The CM selected the sub with the highest labor rate (greater by $10 per hour) of three bidders. The CM had agreed to these higher quoted rates and inserted them into their subcontract. As the Owners representatives, we asked for support for the actual cost and also reviewed the RFP that originally went to the subs. It was discovered in this process that the selected sub had assumed that labor rates should include overhead and profit, while the other subs apparently did not. Also it was discovered that the actual cost of labor was $5.00 an hour lower than the quoted rates even after OH & P was taken out.

DOES THE GENERAL CONDITIONS ESTIMATE HAVE A PAID TIME OFF (PTO) DUPLICATION?

Payroll burden estimates are usually prepared on one of two common ways; with, or without, paid time off. If your CM includes PTO in its payroll burden rate then care must be taken to verify that the CM has not estimated twice the time and cost it will take to manage your construction project, as related to PTO. The issue is that in a one-year project there is only one year's worth of salaries that should be estimated. However, if the CM has included one month's worth of PTO days in their payroll burden, they have actually estimated 13 months' worth of time. Given that holidays, sick time and vacations are taken when they are earned or when they occur, it is not logical to estimate 13 months for a 12-month job. We have just reviewed an estimate where this duplication was $250,000. Luckily, it was caught and corrected before the contract was signed.

UNINTENDED CONSEQUENCES

It is common for us to audit GMP contracts that contain some fixed cost elements. One common fixed element is a payroll burden percentage to be charged in lieu of actual cost. One unintended consequence to fixing a payroll burden rate is allowing that percentage to be billed even if the CM employs part time workers or workers that get few, if any benefits. On one large project we found the CM charging the fixed and agreed to payroll burden rate of 45% on part time security personnel. These off-duty policemen got no benefits and the true payroll burden was approximately 12%. This unintended result netted the CM an additional $82,500 in profit. On the same project, overtime was worked by many of the hourly workers. The total premium OT spent was $450,000. Since these workers got no additional benefits, and W/C does not apply to the premium portion of OT, fixing the payroll burden rate and not specifying a different rate for OT cost the Owner approximately $157,500.

HOW MUCH DO THINGS COST?

On every project, there are changes from the original design and scope. When these changes happen, a CM or a subcontractor will prepare an estimate of the changed cost. These estimates will be reviewed by the CM, then perhaps the engineer or the architect, and then by the Owners personnel. Ultimately, a value is agreed to. Before we get to the main question, we ask you to ponder this, "If everyone tells you the same lie, is it the truth?" So, with our first question in mind, our second question is, "where in this process is the expert on what things cost? Is it the CM? Perhaps, but they may just be passing on whatever the subs give them, or they may have an incentive to inflate the true costs, themselves. Is it the engineer? Perhaps, but if they are not local or in the business of purchasing labor and materials, they may not know the local costs. Is it the architect? Perhaps, but they also may not be local and may not know what labor and material actually cost, other than seeing many CO estimates. Is it the Owners personnel? We hope so, since they are ultimately paying the bill, yet they too may be removed from local markets and purchasing costs.

Our advice to the Owner, is to begin every project with a survey of what the base cost of labor is. As way of example on why this is important, we worked on two projects where the engineer and the Owner's third-party PM were led to believe that labor costs were higher than they really were. In one case, the PM assumed that the base union carpenter wage was $35.00 per hour. With taxes and benefits the CM was billing $50.75 per hour. Unfortunately, in this area, the actual union base wage was $25.00, and the overstatement of cost was $14.50 per hour. Since the Owners PM had a false idea of what a carpenter made, his ability to evaluate all of the other trades on the job was impacted. On another project the CM estimated its cost for self-performed concrete work. The total concrete package was estimated at $17,000,000. The engineer (which was 1000 miles away) was asked to review the estimate and wrote to the Owner that they had reviewed the estimate and agreed to the value, in part because the labor costs were consistent with union wages in that area. The problem with the engineer's review was that the CM was a nonunion company and the workers on this job were nonunion. The difference of $15 per hour reduced the total estimate by $500,000.

Our advice is, at a minimum; determine the base wage of a carpenter for your project prior to starting. This basis will serve you well in then extrapolating the cost of more skilled and less skilled trades. Additionally, determine the base cost of common building materials such as, plywood, EMT, PVC, common wire sizes, copper pipe, etc. This base will allow you to spot check estimated costs and, if these costs are inflated, a more thorough review may be in order.

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INSIDE THIS ISSUE

GL COST BURIED IN PAYROLL BURDEN

As some of you are aware, many subcontractors pay their General Liability insurance as a function of payroll, not sales, but are you aware that some of the largest CM's also pay GL insurance on payroll?

We have recently audited two large projects where the Owner purchased the GL insurance (a GL only OCIP). The Owner assumed that since there was no specific line in the CM's GMP estimate for GL insurance that they did not need to get a OCIP credit from the CM. In fact, these CM's included the cost for GL and Excess Liability in their payroll burden, and therefore no OCIP credit was ever received. The credits due on both of these projects were over $200,000 each, and if not for the audit, the savings would have either been shared with the CM or gone as extra OH and P.

Be sure to review the estimate of both payroll burden and the Cost of Work, when verifying the credit due for a GL OCIP.

CONTINGENCY BURIED IN SUBCONTRACTS

On many negotiated GMP agreements, we see Owners allowing for a contractor controlled contingency. Sometimes this contingency will have some limitation as to what it can be used for, but sometimes not. As to allowing a contingency, we also often see smart Owners insisting that all unused contingency is returned to the Owner before any shared savings, if any, is calculated. Regardless if the owner agrees to a contingency or not, we have seen certain CM's being very aggressive in imbedding allowances and contingency in the subcontracts, at buyout, thereby making the subcontract appear larger than it really is and lessening the appearance of buyout savings.

On a recent audit, the CM had told us that the final amounts due to the subs would be paid after the Owner had paid them. They also told us that the difference between the current subcontractor billed amounts and their contract values, was the subcontractor related cost to complete. What they did not tell us was that there was $800,000 in unreconciled subcontractor contingency buried in the subcontracts. Had an audit not been performed, or if we had not reviewed the subcontractor's scope of work language thoroughly, this $800,000 may have become additional CM fee.

MANIPULATED BID PACKAGES

One of the duties required of a CM is to prepare subcontractor bid packages. It is assumed that the CM will prepare these scopes of work in such a way that subcontractors can perform the work required and actually bid on the work. On a recent project, we reviewed one such bid package and found the following scope included for one sub to bid on:

- Doors Frames and Hardware, Material and Labor Site Furnishings
- Metal Lockers Overhead Doors
- Exterior Maintenance Equipment Floor Mats
- Specialties Operable Walls
- Perimeter Protection

We have never seen these disparate scopes of work combined into one bid package, but, not surprisingly, the CM expressed their interest in "bidding" on this work. Also, as their luck would have it, they could only find one other sub to bid (which was very high and located 350 miles away) and the work was awarded to the CM on a fixed price basis.

Obviously, an Owner must be very diligent in reviewing the bids and the solicitations for bid, when considering allowing the CM to perform any work on a fixed price basis. Just as important is reviewing the bid package to verify that work is normally performed by one subcontractor. In the above example, even if the Owner did not know what work is normally performed by a sub., when there are too few subs bidding, they should have asked that the CM break the bid package into smaller scopes of work and of course not allowed the CM to perform the work on a lump sum basis.

CAPTIVE INSURANCE COMPANIES

Larger Contractors and subcontractors sometimes form "captive" insurance companies to shield themselves from certain insurance risks but also allow a participation in avings due to superior loss performance. Another significant captive advantage is tax deference.

Captives are most commonly associated with offshore locations, like Grand Cayman or Bermuda, where tax laws are not as punitive as other locations, but also certain states like Vermont boast many captives. Some "captives" are formed and owned just by the contractor and some are jointly owned by several contractors. There are even "rent a captive" programs available where the contractor does not have to go to the expense of setting up a captive.

Captives hold another advantage for many contractors, they allow the contractor to show an owner an insurance policy, complete with rates, which in turn allows the contractor to charge the captive "cost" to the project. Since the captive rates are not guaranteed to be the final cost to the contractor, these rates usually do not represent the actual final cost. Additionally, since the contractor is negotiating the rates with its own captive company, the cost of insurance, as represented by the captive rates, is suspect. Seldom, if ever, have we had a contractor unilaterally divulge that they are dealing with a captive. Typically, the existence of a captive becomes known when you see;

1-An insurance company that is unfamiliar, 2-The insurance company address is one of the locations previously mentioned. 3-The insurance purchased is of a type not normally seen (like warranty insurance or deductible insurance).

Assuming you have related party language in your contract, as we have advised, then requiring a full accounting of captives' costs, claims, and covered contract values, should enlighten you as to the real cost to the co ntractor, rather than the stated captive charge.

HIERARCHY OF DOCUMENTS

All good contracts have a hierarchy of documents. In the AIA documents, this hierarchy goes in this order:

- The AIA Contract, including attached exhibits
- The AIA General Conditions (A201)
- Specifications
- Drawings
- Addenda issued prior to the contract, and modifications issued after the contract. (Modifications after the contract include Change Orders and Amendments.)

We often see a CM trying to insert into a CO, or mendment, qualifying language that is intended to supersede the base contract as to reimbursable cost. In the qualifications to a CO, establishing the GMP, we sometimes see language where the CM inserts a fixed price or the percentage for some element of cost that otherwise was a reimbursable item, at actual cost, in the contract, thereby creating a conflict between the base contract and the Change Order. Given the hierarchy of documents found in the standard AIA A201, it seems as if this conflict is resolved by the contract language governing over the CO language.

Obviously this would not be true if the CO stated that the old language was changed and the new language should take its place. In that case there would not be any conflict, because it is clear which language the parties intended to use.

To be clear, as they say, we are not lawyers, we just play them on TV. We preach constantly to review all of the fine print in Exhibits, Change Orders, and Amendments, to make sure that conflicting language or false expectations are not present, however, we want you to not be so fast in assuming that any "gotcha" language that was inserted by your CM into a CO necessarily trumps the negotiated language of your contract.

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INSIDE THIS ISSUE

AUDITING PAYROLL BURDEN COSTS

We wrote last time that we have been asked repeatedly to write a definitive article on how to audit the costs of payroll burden. This is the third of three discussions on that subject. While the subject may seem simple, because of the complexity of the various parts and pieces, it is far from simple to describe how to calculate.

Nevertheless, here is an attempt, but there is much that is not covered in this writing. Affiliated Entities Also, keep in mind that each company does not have only one payroll burden rate. Most construction companies have both salaried and hourly employees and each group has its own very distinct payroll burden cost profiles. Also within groups, the cost profile can change dramatically, such as between regular pay and overtime pay. So any company trying to sell you one burden rate for all three types of cost is typically doing so for a reason, and it is not for your benefit.

Payroll burden is a commonly used term, but other terms that are also used to connote the same thing are labor burden, payroll fringe costs, PT&I, PTIB, and labor fringe cost. These all typically consist of three distinct types of costs, payroll taxes, payroll-related insurance, and employee benefits. These costs are all mentioned in Article 7.2.4 of the AIA A102 contract. In this newsletter, we will finish our series by discussing employee benefits.

PAYROLL BENEFITS: Employee benefits typically include all of the benefits that a construction company gives to their employees, however this may be modified if your construction contract limits certain benefits, like profit sharing. Benefits are defined usually in the contract, but basically can be defined as all of those contributions made by a company for their employees that are not classified as wages. We typically associate health insurance, vacation, holiday pay, and retirement costs with the term benefits, but certain other items may be included, like life and dental insurance. In some cases, employee benefits are paid by the construction company to a union rather than to the employees directly or to an insurance company. Benefits usually do not include anything that an employee would not consider in their evaluation of pay and benefits. Therefore, a benefit to the employee would be tuition costs reimbursement but not safety training, auniform allowance but not small tool expense. A short course in each typical group of benefits is discussed below.

HEALTH INSURANCE: Companies buy health insurance through an insurance company like Blue Cross and Blue Shield, as an example. Most medical insurance policies differentiate employer coverage costs by groups such as employee only, employee and spouse, employee and family, etc. Also, most construction companies require their employees to contribute some of the total cost through a payroll deduction. Medical costs typically are therefore not specifically related to how much an employee earns. The company cost to cover an employee is the same if the employee makes $25,000 a year or $100,000. To determine an average cost per employee earnings, one must determine the average costs per month to the construction company per typical employee and reduce that amount by the employee contribution. Then the average net cost per month must be divided by the average employee monthly salary. A similar calculation should be done if one is trying to determine the average percentage rate for an hourly employee. One key element to keep in mind is that not all employees elect insurance coverage. The percentage of employees electing to not have health insurance is inversely proportional to employee pay and age. Additionally, most companies have some waiting period before an employee is eligible, but this fact is usually not significant unless there is a high turnover. Also, as may be obvious, no additional health benefits are incurred by a construction company if the company incurs any O/T expense. Therefore, no additional payroll burden is typically calculated on O/T pay.

If the contractor or subcontractor is affiliated with a union, the union benefits costs are specified in the union agreement. These costs can be expressed as a rate per hour worked, a percentage rate per dollar earned or a combination of the two. Obtain a copy of the union agreement to make the proper determination.

VACATION AND OTHER PAID TIME OFF: Most companies offer some paid time off to their employees. For salaried persons this benefit can typically include two to three weeks' vacation (on average), 6-8 holiday days and several personal days that may include sick pay. Some companies elect to include this benefit in their calculation of payroll burden and some elect to charge the actual days, when taken, directly to job cost. It is important to confirm that both costs are not being charged, as it is common. The correct calculation of the burden percentage to be used is to calculate the total average paid days (not the total allowable days) and subtract that number from the total available work days in a year (5 days X 52 weeks) or 260. Then divide the total paid days by the average chargeable days to determine the correct paid time off percentage. The calculation is the same for both salaried and hourly employees, yet care must be shown in determining the actual paid benefit. Most companies have more turnover among the hourly group and therefore some benefits do not accrue to those employees at the same degree as to salaried. Again, no additional paid time off is incurred by the construction company for OT paid.

RETIREMENT COST: Many companies have some level of retirement benefits. The benefit can be minimal, 1%-2%, or substantial, 10% - 15%. Almost all companies have some waiting period before an employee can enroll in the retirement plan and therefore before the company begins incurring costs. The waiting period can be as little as three months or as long as one year. Companies also do not generally have to pay benefits if an employee leaves in the middle of a plan year. Therefore, a company could offer a benefit of 15% retirement on eligible wages, but the average actual cost could be half of that amount. Also, another key consideration is the vesting period. Vesting is the calculation of what amount of the employer contribution actually belongs to the employee. If the employee leaves before they are fully vested, sometimes the other employees get a bonus of that employee's unvested amounts. In other cases, the construction company can effectively reclaim the unvested portion, thereby reducing the overall effective cost of retirement. To derive the true average retirement percentage, one must determine the actual employer contribution for a given year and divide that sum by the total of all wages. All wages here is not the same as all eligible wages, as previously noted.

Assuming all employees are eligible and contributing the maximum amount to their 401(k), it is not uncommon for a company's actual cost to be between 50% - 75% of the maximum cost,

Retirement plans vary, but one common version is the 401(k) plan, where the employer matches some level of contribution from the employee. An example is where the company matches up to 50% of the first 6% an employee puts into the retirement plan. In this example, if everyone on your job is enrolled in the plan (meaning that they have met the minimum eligibility requirements of being employed at least 1000 hours for example) and if every person that is eligible saves at least 6%, then the actual contribution will be 3%. As you can imagine, not everyone is usually eligible and not everyone contributes at all, not to mention the full 6%. The salaried group of employees is more likely to try to maximize this company benefit and the hourly group often does not see the true value, since to them; a dollar today may be more valuable than $1.50 in the future. Therefore, it is not uncommon for the actual cost to the company to be 50% to 75% of the maximum cost which assumes all employees are eligible and contribute to the max level.

RE-RENTALS FROM AFFILIATED ENTITIES

Some CM's seem to have no shame. We have seen several that are not content just to rent tools from an affiliated company, and act as if the arrangement is at arm's length. Recently we have seen these affiliated companies charging for tools they don't have and services that they don't provide. How? They rent from a real rental company and then mark up the rental cost. Then they charge to the CM as a re-rental or contract for services, like dumpsters and haul off, mark up the cost, and re-invoice the CM for the service. We think this is the definition of easy money.

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AUDITING PAYROLL BURDEN COSTS

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First, is a definition of the subject matter, payroll burden. **Payroll burden is a commonly used term, but other terms that are also used to connote the same thing are labor burden, payroll fringe costs, PT&I, PTIB, and labor fringe cost. These all typically consist of three distinct types of costs: payroll taxes, payroll related insurance, and employee benefits. These costs are all mentioned in Article 7.2.4 of the AIA A102 contract. Below we will continue our series by discussing payroll related insurance.**

PAYROLL INSURANCE: Payroll insurance will almost always include workers compensation (but this may be incorrect if you have a CCIP or OCIP project) and may include GL insurance as well, since some GC's and the majority of subcontractors pay for their underlying GL insurance as a function of base labor. Payroll insurance cost is determined by an insurance policy. Therefore, to determine the true cost, one must see the policy, and specifically, the rate pages from the policy. These two types of insurance, W/C and GL are discussed below.

WORKERS COMPENSATION INSURANCE: All construction companies are required to have W/C insurance. These insurance policies are typically unique to each construction company as to the rates and modifiers, but they usually have some common elements. Each W/C policy has different policy rates for different classifications of workers. These W/C classifications have their own W/C codes. A typical policy will have Carpentry (for example; comp code 5403), Executive Supervisors (comp code 5606), and clerical (comp code 8810). The rate page from the policy almost always shows the expected payroll dollars, the policy rate by comp code, and the extended expected premium, before modification. The sum of all of these expected premiums for each classification is then modified by several different factors, including an experience modifier. An experience modifier is assigned to each company each year based on that company's past actual claim experience. Companies that have good safety records pay less than the policy rate (think of the policy rate as list price) and those with bad safety records pay more than the policy rates. Additionally, many insurance companies offer other policy discounts and credits. It is not uncommon to see a construction company pay only 50% of the policy rates. So, the rates by classification can vary widely. A concrete rate can be 15% or more before credits, while an executive supervisor rate can be 1.5%, a difference of ten times. This is one example of why one burden rate does not fit all persons. It is also useful to know that in the vast majority of states these effective rates do not apply to overtime premium pay, only base pay. So, a worker who gets paid $10 an hour and works 50 hours, actually earns $10 X 50, plus $5 X 10, or a total of $550, but the construction company pays W/C on only base pay of $500 ($10 X 50 hours).

GENERAL LIABILITY: Many construction companies pay for GL insurance on total revenues, however those companies that pay GL as a function of labor (like many subcontractors), would typically include GL in their calculation of payroll burden. GL insurance policies would show the rates per thousand dollars of earnings not per hundred as in W/C policies. Also the rates are broken down between BI and PD (Bodily Injury and Property Damage). So, one must add the two policy rates together (by classification yet the GL classifications are different codes than W/C) and divide by 1000 to get the rate percentage. Again, as with W/C these rates do not apply to the premium portion of OT.

HOW DO I KNOW IF AN OCIP IS RIGHT FOR ME?

As you may know, OCIP is the acronym used to stand for Owner Controlled Insurance Program. Typically, an OCIP will include onsite W/C coverage, GL insurance and Excess Liability insurance, however some OCIP's will cover GL and Excess only. We have some clients that were contemplating these programs recently and have discovered that sometimes the costs and benefits had not been explained completely by their brokers. We thought that we would add to that conversation.

You probably are aware that the cost of the OCIP must be measured against the avoided cost. The cost of an OCIP is the insurance paid, the expected/actual claims paid and the brokers fees and commissions, at minimum. The avoided cost is the amount of money you will not have to pay to the Construction Manager/General Contractor and their subcontractors, since you are providing that insurance instead. The difference between the two is how most Owners measure if the OCIP saved them money. The concept is straightforward, but the details and calculations can be tricky. Many Owners solicit advice on this expected value of avoided cost from their insurance brokers. Yes, the same persons trying to sell them the OCIP program. Is it any wonder that this advice is sometimes very inaccurate? We sat in on a meeting a couple of months ago where a national broker told the Owner that the avoided cost of a W/C and GL/Excess OCIP could be between 20% and 30% of the entire construction cost. We tried to ask them if they had misspoken but they insisted that the figure was accurate. Obviously if an Owner were to believe numbers like this, then is it any wonder that they would consider buying an OCIP that might cost them only 2.25% of construction cost?

We have been involved in hundreds of OCIP projects over the last 20 years. On many of these projects, a true accounting of the avoided cost was not performed,however on the many projects where an accounting of the avoided cost was performed; the usual avoided cost is 2% to 2.75%.

With this benchmark as a point of reference, you can roughly compare the highest, lowest and expected cost of an OCIP.

You may wonder how a true accounting of the avoided cost was accomplished. Tracking avoided cost is usually performed by the Owners insurance broker by asking the enrolled contractors and subcontractors to provide insurance cost documentation, through copies of policy rate pages (just as we discussed in the first article) and also on-site payroll data, though certified payroll reports. These two elements, along with the contract amounts, allow the broker to calculate the cost that the contractors would have incurred if they had been required to pay for the insurance themselves. Sometimes Owners will write into the contracts that the final calculation of the avoided cost will be deducted from the contractor's lump sum contracts. In these cases, those Owners know exactly what the avoided costs are and then can compare that credit amount with the actual cost of paying the insurance, claims, and broker's fees, to see if the effort saved money.

You can require your insurance broker to perform an estimate of the expected avoided cost in much the same manner, using estimated values for actual values. This would require them to analyze the expected-on site labor cost, spread this labor into the expected W/C codes and values, and estimate the credit cost for GL and Excess Liability. If your broker is knowledgeable, they should have all of the data to perform such an analysis, even if they are reluctant to do so. If you do ask for this analysis, be prepared to review the details critically. We have seen brokers intentionally overstate W/C rates, experience modifiers, and GL and Excess Liability cost, just to make the estimated expected credits greater.

It was a wise person that first said,

"buyers beware".

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PAYROLL TAXES: Payroll taxes are almost universally made up of three taxes; FICA, Federal Unemployment (which often is called either FUI or FUTA), and State Unemployment (SUI or SUTA).

• FICA consists of both Social Security Tax and Medicare. SS is currently calculated at 6.2% of the first $110,100 (2012) in each employee's wages earned each year, and 0% for earnings in excess. Medicare is calculated at 1.45% on all wages.

• State Unemployment tax also is subject to a maximum per year, yet the maximum varies by state. The rate (%) that applies to those wages also varies by State and often by company. Maximums range from $7000 for California to $38,800, in Hawaii. The rates also vary from as little as 1% to as much as 10%.

• Federal Unemployment is largely the same for all companies and all states (except if the State has borrowed from the Federal government and has not paid the money back, in which case the amount can increase slightly). The current rate is .6% of the first $7000 each employee earns in a given year.

Given the above, it should be obvious, that a company that fails to reflect the earnings maximums can greatly overstate the payroll burden related to payroll tax. An easy method of determining if the Contractor is attempting to apply an average cost is to look at the percentage used for FUI. If it is stated at .6% then you can be fairly confident that they are not calculating an average payroll tax rate.

Assuming this event, a shorthand attempt at developing an average is to assume a weighted average wage per year for the GC. For an hourly payroll burden calculation, it could be based on what a typical hourly employee makes per hour (say a carpenter) and some assumption of how many hours that typical worker works for the company in a year. Since not all employees work a full 2080 hours, a more realistic guess is around 1600. Then applying the hourly rate times 1600, tells you what that person may earn per year. Next divide the FUI maximum of $7000 by your employee cost per year and come to a percentage to be applied against the full FUI rate of .6%. That new rate is the rate to be substituted for the rate used by the contractor.

The same calculation should be performed for both FICA and SUTA. Most hourly employee calculations will not modify the FICA rate, given the max is $110,100, but will change the SUTA rate. However, when the same logic is applied to a salaried payroll tax rate, some FICA difference may be noted.

Depending on the state and the contractor, we have seen differences of 7% and 8%, between the assumption that all employees are fired at $7,000 (the logic associated with the contractor not using the maximums) and our use of a company average.

IGNORING THE OBVIOUS

As auditors, we are often asked to review the pricing of Change Orders. Most of the time, we are asked to do this after the Change order is already signed. Even though many contracts seem to obligate the CM to adhere to the contract terms, and not allow subcontractor markups more than some stated amount, these CM's seem often to ignore obvious overstatements of cost.

As Owners, you may already be aware of some of the most common tools, readily available to you and the CM, to spot check sub pricing.

Many of the projects we work on are OCIP or CCIP projects (Owner Controlled Insurance Programs or Contractor Controlled). We also work on many projects that have some requirement for a minimum prevailing wage.

One common element of these types of projects is that the subcontractors are required to submit certified wage schedules to the CM or the Owner. Our experience is that these reports, which list the true hourly base labor costs, are never used by the CM in evaluating the reasonableness of subs labor pricing. On one recent project, the subs actual base labor was $21 per hour but their CO's had $30 per hour. This $30 per hour "estimate" was used on pricing of $800,000 worth of CO's.

Another obvious tool in evaluating sub material pricing is to review online prices at large warehouse tool stores versus supply stores. You can readily check prices for EMT, plywood, wire, PVC, etc. On a recent project, the CM allowed ¾" EMT pricing from their electrical sub that was double what the sub could have bought EMT for at Home Depot. The check took about 3 minutes. Further checks on common material items showed the same markup. This sub was given almost $1,000,000 in CO's.

CHARGING FOR THE INSURANCE DEDUCTIBLE

How many of you have experienced an issue on a project where a relatively small claim against the CM's general liability insurance should have taken place? If so, did the CM inform you that the claim was too small to involve the insurance company, due to the CM's deductible?

We have seen this scenario numerous times on GL, Auto, and even Workers Comp. claim situations. At issue, is whether the amount charged by the CM for these types of insurances, include a factor for the deductible risk. Our experience is that almost 100% of CM's/GC's include some value for the small claims that are paid out of pocket, rather than covered by insurance. These estimated deductible claims sometimes make up 30% of the total estimated insurance cost. If your CM can charge the actual deductible claim to you directly, they have made money, of course at your expense.

"In evaluating sub material pricing, review online prices at large warehouse tool stores versus supply stores…On a recent project, the CM allowed ¾" EMT pricing from their electrical sub that was double what the sub could have bought EMT for at Home Depot. The check took about 3 minutes. Further checks on common material items showed the same markup. This sub was given almost $1,000,000 in CO's."

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MANIPULATING BID PACKAGES

As most of you are aware, Construction Managers and General Contractors, often see self-performed work as an opportunity to make additional fee. In this area, we Packages have seen CM's and GC's, in different parts of the country, employ similar strategies in the manipulation of bid packages. This bid package manipulation allows the CM to perform the bid package work as if they were a subcontractor, for a fixed price. The Work isn't Self basic scheme is fairly easy to understand and surprisingly easy to pull off, apparently. If you are the CM, the scheme is as follows: 1 - Develop one or more bid packages where the scope is so general in nature that there is no subcontractorwilling to bid on that package. 2 - Turn in a lump sum price to the Owner or yourself, for that Work. 3- Ask the Owner to authorize you to do the Work. 4- Bill the Work on a lump sum basis.

As absurd as it may seem, we have seen bid packages, within the last year, where be buying coffee for the GC's personnel, among other items, was included as a part of the bid package for General Trades work. In fact, General trades work (many of us still call this General Conditions) is the most common "package" that a CM tries to bid out if they are trying to manipulate the sub bid process. Since this General trade arrive at a GMP? work can include: misc. blocking, clean up as needed, dewatering as needed, safety protection, coordination of LEED dumpsters, and punch list coordination, you can see why no real subcontractor would bid such work. They would have to have a crew, including a superintendent, on the job, full time, from beginning to end, just in case they were needed on a given day. Of course the whole scheme does work better, for the CM, if they can actually get at least one bid from a real subcontractor, and it does not hurt if that bid is ridiculously high. In fact, this last year we have seen one GC create fake sub bids for bid package work, when an adequate number of real bids were not available, just to make the CM's own self performed bid look better and more legitimate to the Owner. We have also seen cases, on two separate projects, where the CM was a JV and one of the joint venture members took turns in "bidding" on these manipulated bid packages, just to make sure both companies got their share of the additional profit. Also this JV arrangement had the added benefit of contractually allowing the JV/CM entity to say that they did not do any self-performed work.

Another manipulation of bid packages that we saw this year was a CM attempting to bid out a "hoisting package" which included cranes, man hoists, and forklifts. No subcontractor or single rental company would be willing to bid on this scope, yet that is exactly the scope that was presented to the Owner as a bid package that the CM wanted to "also" bid on as self-performed. In this case, the Owner with our assistance rejected that package and instructed the CM to perform the necessary tasks as Cost of Work, without additional self-performed fee.

Our advice is to review all bid packages carefully, don't allow any self-performed work to be performed on a lump sum basis unless there are extraordinary circumstances and be especially wary if a bid package has one or less bidders.

WHEN SELF-PERFORMED WORK ISN'T SELF-PERFORMED

Dovetailing with the previous subject is the situation that presented itself many times this last year; A CM is allowed to self-perform some scope of work, only to discover during the audit, that the actual work was performed by subcontractors, whose cost was also in the Cost of Work. General cleanup is one such item, where the CM required the subs to participate in a composite cleanup crew to clean all unidentifiable debris. The CM, in this case, actually incurred no cost for cleanup, even though $50,000 was billed to the Owner. Another case involved a CM who billed an Owner for installing doors, frames, hardware, and also misc. blocking, when in fact the drywall sub performed the blocking and a misc. specialty sub did the doors and hardware installation.

A takeoff on the same theme is the case where the CM tells the Owner that they were going to self-perform drywall and actually subcontracted all of the work to a real sub. On a Hospital project the CM told the Owner that they were going to self-perform the purchase and installation of the mechanical equipment screens for a price of $40,000 and subcontracted the work to the Mechanical sub. Both the actual cost and the $40,000 were billed to the Owner.
The largest additional self-performed fee money maker for CM's is the concrete package. Here the CM includes all concrete-related work in one package and asks the Owner to allow them to bid on this work as well. The concrete package would include, concrete materials, concrete pumping, horizontal place and finish, vertical place and finish, forming, rebar materials, rebar installation, reinforcing steel and installation, placing of embeds, and perimeter protection. In the list here, often only vertical place and finish and placing of embeds is actually performed by the CM's employees. As much as 85% of the Cost of the Work is either subbed to other companies or simply purchase orders for materials. Because so much of the work is not actually self-performed, you can guess that few subcontractors are in the business of bidding on all of that work. Even if a sub was willing to bid the work, most would also be aware that the CM would have the upper hand in negotiating with the Owner for this work, so there may be very little chance of getting legitimate bids anyway. Requiring the CM to break up these concrete packages into smaller chunks and getting real bids from subs that are really going to do the work, is the only way to keep from paying an extra fee for nothing.

"On a hospital project the CM told the Owner they were going to self-perform the purchase and installation of the mechanical equipment screens for $40,000 but used a Mechanical sub to do the work. Both the actual cost, and the $40,000 were billed to the Owner."

YOU JUST THINK THE GC BOUGHT SUBGUARD

We have been warning you of the various tricks a CM may try when using SubGuard. We have recently heard from industry sources that some of you are resisting using SubGuard altogether. On larger projects, where the average bond cost is less, this may be a very prudent decision. On smaller projects we have encountered a situation recently that we had not seen previously. The CM told the Owner that they were purchasing SubGuard or something very similar that they called SDI (subcontractor default insurance). However, when we went to audit the actual cost of such insurance and to verify that the insurance existed, we were told that there was no policy at all. The CM had self-insured all of the risk, rather than having a large deductible as in SubGuard. While the Owner has the protection of the GMP in these cases (meaning even if there is a sub default the maximum amount the Owner can pay is the GMP), we wonder how many CM's are doing the same thing and pocketing about 1.2% of the subcontract values from unsuspecting Owners.

Our advice is to require the CM to prove that the subs and PO's that they are billing you SubGuard (or SDI) for are actually enrolled in the SubGuard program. The same thing can go for sub bonds. Before you pay for a sub bond, get the CM to show you the bond itself.

SHOULD ALL INSURANCE DEDUCTIBLES BE INCLUDED IN FEE?

The true value of an insurance deductible can be extremely difficult to determine. Actuarial assumptions or recommendations from insurance companies and agents can be manipulated. In most situations these deductibles are related to GL insurance, but W/C insurance can also have large deductibles also. In fact, it is common that a CM will attribute over half of their GL cost to the value of the deductible. Since we regularly see CM asking for 1.2% to 1% for GL, you can see that up to .5% of the total contract amount is subject to value that is somewhat arbitrary and certainly biased. One of our clients has sought to take this impreciseness out of the negotiations by stating in their contract that all insurance deductibles are not reimbursable. A CM with a large GL deductible may, therefore, end up having a higher fee but a correspondingly lower Cost of Work. Some CM's may elect to buy down the deductible for a given project. Buying down the deductible requires that the CM purchase additional insurance. This insurance premium is reimbursable. On one project this year for this Owner, the CM had originally asked for .4% to cover their GL deductible risk. The GL actual deductible buy down policy cost only .1%. Therefore, the Owner saved .3%, or $210,000, on a $70 million project.

WHAT IS NEEDED TO ARRIVE AT A GMP?

On two different projects this year we ran into a CM who had intended to establish an initial GMP with the electrical and mechanical subcontractors and then ultimately convert these GMP's to a lump sum after all of the design documents were fully completed. The reason for entering into a subcontract before the documents were complete was that the CM wanted to get the subs input on design issue and some work needed to start prior to drawing completion.

This scenario probably does not seem unusual to most of you, and while this is somewhat common, we would be concerned that the conversion of the GMP to lump sum would be accomplished only if the Owners' interests were best served by this conversion. After all, if we have a GMP, why would we convert to a lump sum for the same price? But on these two separate projects with different CM's, we had other problems, one of the CM's never asked for the subcontractor's fee, just their GMP. On the other project, the CM asked for a fee % but never defined what the Cost of Work was or wasn't.

Many Owners want to let the CM control the process as much as possible and they do not want to be too meddlesome but asking a few questions of your CM might be good, because as you can imagine, it is hard to have a GMP without the fee or Cost of Work defined.

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PROFIT CENTERS AND FEE ENHANCEMENT

We are often asked to list the greatest areas of additional fee enhancement employed by GC's and Construction Managers. The list below is just the most common areas.

SUBGUARD: The quoted costs by many GC's is between 1.5% and 1.1% of subcontracts and purchase orders. Lately we have even seen a trend in contractors quoting Subguard, at the same rates, as a function of total construction cost as well, not just subcontracts. True cost to a GC appears to be somewhere between .5% and .6% of subcontracts, but like all insurance, the risk of a default on any one project could cause the GC to be out of pocket, from the deductible costs not reimbursed by Zurich, $750,000 to more than $1,000,000 per claim. On a recent project, the GC joint venture charged the Owner SubGuard on one of the joint ventures affiliate's costs as well as subcontractors. When discussing large projects greater than $50,000,000 it is often useful to try to calculate what the actual subcontractor bond cost would otherwise be and then refuse to pay $1 more than that, at a minimum.

GL AND UMBRELLA INSURANCE: True cost to a GC is typically less than .4% but many GC's often try to charge at least double to triple that .4% amount. We are working on a project in which the GC charged .45% and the Owner provided the GL and Umbrella. Because of the difficulty of calculation, due to many factors, on large projects, we believe the best approach is to require the GC bidders to quote a fee that includes all insurance except Auto and W/C. We have witnessed this approach on many projects and the fee quoted was often three quarters of one percent less (.75%) than the breakout price of fee and GL insurance on other similar jobs.

PAYROLL BURDEN: Most GC's overstate one or more items within the payroll burden charge. One way to overstate cost is to include costs that are not otherwise reimbursable (bonuses based on profitability for instance). Another way is to simply overstate the true cost of an item, like health ins., pensions, or taxes. Additionally, a GC could simply charge some items both directly, as salaries, and also as a payroll burden item (vacation and holidays are typical). The best way to manage these issues is to make the contract clear, don't agree to a fixed payroll burden rate, and perform a pre-audit.

SHIFTING OVERHEAD COSTS TO JOB COST: Shifting costs, such as recruiting, to job cost is an example of this trick. A larger issue is charging a percentage for data processing, data storage, home office accounting, and corporate safety departments as if it was a reimbursable cost and variable to construction volume.

SHARED SAVINGS: What sounds like a good idea often ends up with a GC manipulating estimates and bids to "create" savings that becomes a bonus. A recent project had the GC billing a $500,000 shared savings bonus. Review of the original GMP estimate showed that the GC had increased the subcontractor bid amounts by $1,200,000 prior to preparing the GMP thereby creating savings and "earning" a shared savings bonus. Additionally, some Owners allow a stated contingency to be added to the GC's estimate of costs. Occasionally, the Owner forgets that the shared savings provision may apply to those funds as well and ends up paying a bonus for estimated padding that the Owner allowed.

EARLY COMPLETION BONUS: The GC uses the Owners money (unspent funds within the GMP from buyout savings or contingency or allowances built into the subcontract values) to fund acceleration costs to subcontractors to achieve an earlier completion and to earn a bonus. So the Owner ends up paying all of the costs so the contractor can get a

bonus. Additionally, the Owner is inviting a fight with the GC who will now claim that the earlier completion was possible except for Owner interference by not making decisions or by asking for changes to the work.

SELF-PERFORMED WORK AND FEE: Some Owners allow an additional fee for self-performed work while other Owners allow a GC to bid certain work and possibly perform the work on a lump sum basis. Both approaches are ripe for manipulation. The possibility of an additional self-performed fee, or lump sum work within a larger GMP, for a contractor is like putting chum out in shark infested waters; it is sure to attract attention. For an Owner, it is too hard to define what self-perform means, what the fee should apply to and what it should not, too hard to monitor and verify, too hard to verify that real bidders are actually bidding for real, and next to impossible to verify and require the GC to structure bid packages that make sense. A recent project had a GC creating a misc. work package, to be bid by themselves and others, that included purchasing coffee for the trailers, among other items. Another recent project had the GC applying a self-performed fee to a scope of work that was 100% purchased through one subcontractor. Lastly, is the case of a GC charging the Owner for self-performed work, on a lump sum basis, and buying most of the cost through subcontractors that were also charged 100% to the Owner.

CONTRACTOR CONTROLLED INSURANCE PROGRAMS (CCIP): The concept seems seductively simple and worthwhile, one provider of W/C and GL insurance for both GC and subcontractors at the same or reduced cost to the project. However, the reality is sometimes much different. Many times, the Owner is faced with negotiating a CCIP rate without any information on what true GC and sub cost, is. Pegging CCIP cost to subcontractor deducts can be just as subjective, especially if the deducts are negotiated by the GC at the same time as the subcontract buyouts are being awarded and therefore subject to manipulation by the GC. Buying subcontractor Umbrella/Excess liability insurance is also problematic, given that subs purchase such insurance as a fixed cost and therefore cannot credit the project for credits they do not actually receive. We have seen some GC's using CCIP as a way of front end loading the billings or duplicating costs billed. Regardless, it is our view that unless the project requires a specific insurance that is not readily insurable by subcontractors, a CCIP is not typically an option that reduces cost and, in many cases, actually increases the cost of the project for the Owner.

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INSIDE THIS ISSUE

TEAR DOWN THE WALLS

A long time ago, some of us worked at a company that believed in partnerships and few walls. Partners and employees alike had desks in the middle of the office floors where everyone could see everyone else going about their business. This concept is in stark contrast to the job site we witnessed a few weeks ago, where the compound had office trailer after office trailer, all largely inaccessible to Certificate the Owner, or other members of the project team, who each had their own trailer fiefdoms. No one trusted anyone else. Each kept their own files, many of which were duplicated. Distrust and loathing filled the space between the trailers.

Similarly, we have seen a project early this year where the Owner had to make an appointment to be allowed into the Contractors project site office and then, were Beginning only allowed into an exterior conference room.

We wonder when we decided it would be in the best interests of the project for the GC, Owner, and Architect to all have separate job site offices? Who first initiated this concept? Was it the GC, or the Owner, or was it just a natural byproduct of the win/lose contracts that we enter into? Regardless, how bad could it be if the Owner, GC, and Design consultants shared one space, one set of files open to everyone on the team, one set of contract documents, drawings, and common support staff? What if we all knew each other's budgets and helped solve each other's problems? What if we all celebrated each other's successes and marveled at each other's children and grandchildren? How much money would we save, how much more productive would we be, and how did we get here instead?

NO END TO CREATIVITY

As you could guess, auditing could get boring if it were not for the bottomless pool of contractor creativity. Our experience shows that this creativity is greatly enhanced when there is a profit motive, otherwise known in GC lingo as an "unaudited opportunity".

On a recent project, the owner had agreed to fixed un-auditable general conditions. The GC, seeing his clear shining path in this world, negotiated with an individual to perform Superintendent duties (of course, a part of the fixed GC's) but to also perform key subcontract responsibilities like windows and framing. It will come to no great surprise that all of these costs were charged to the subcontracted cost to be reimbursed and none were charged to the fixed GC's. Based on the estimated cost of the GC duties subcontracted, it appeared as if the Owner was overcharged $360,000.

A SUBGUARD INSURANCE CERTIFICATE

We were visiting with an Owner representative recently and, of course, the subject of SubGuard came up. This Owner had just begun a project where they had agreed to pay a flat percentage on all subcontracts and PO's. We asked if they were sure PO's were covered and if they had seen the policy along with all endorsements. The Owner asked, "What endorsements?"

SubGuard policies can either include PO's or exclude them. Sometimes PO's are excluded unless they are reported to Zurich within a set limited time frame. We had witnessed the aftermath of a project where the GC had billed the Owner for SubGuard on all subcontracts and PO's. A major supplier refused to honor the terms of the PO and it was discovered that no SubGuard coverage existed even though the Owner had paid the money to the GC. We have also witnessed many projects where the GC had billed the Owner for SubGuard on subcontracts that were never enrolled because these subs were bonded. The largest one of these "clerical errors" resulted in a credit of $500,000 to the Owner.

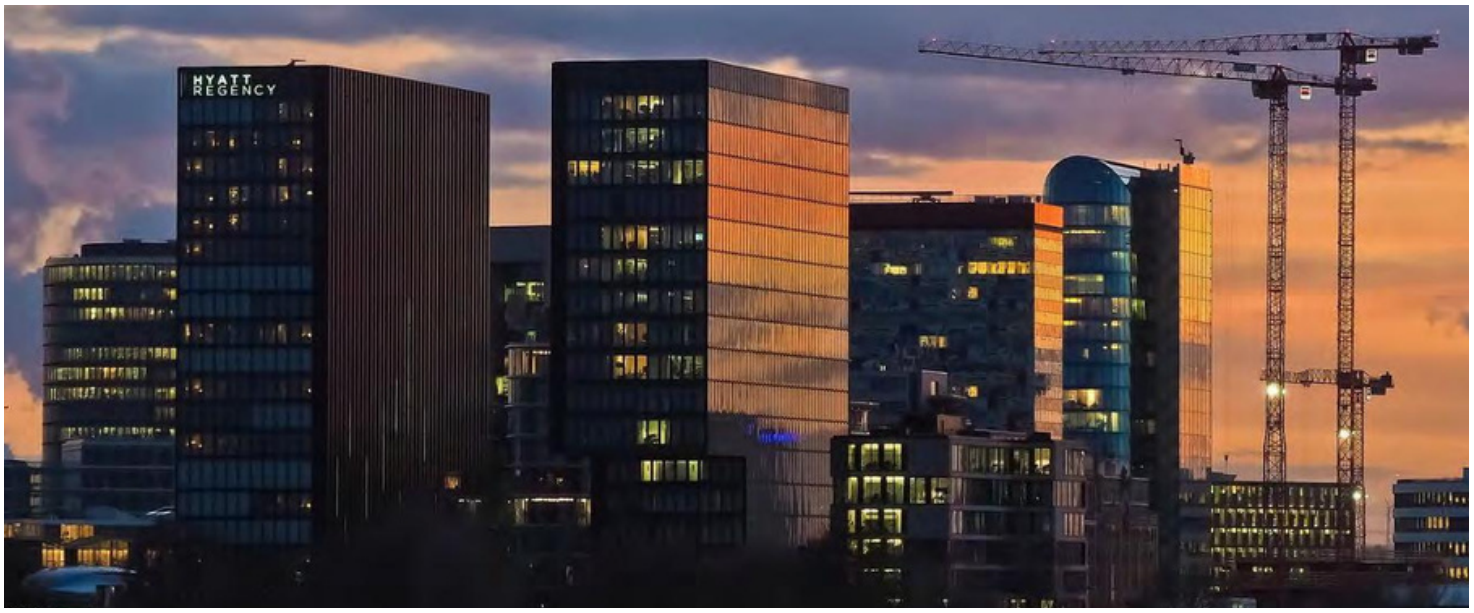
So our question is, how can we avoid these types of situations? What if we required the GC to give the Owner a SubGuard Insurance Certificate? Such a certificate would be obtained from Zurich and indicate which subcontractors and suppliers were actually enrolled. Theoretically, this certificate would deter the GC from billing for SubGuard on subcontractors/suppliers not enrolled or anticipated.

ALLOWANCE RECONCILIATIONS

Another new audit twist came up in the last few weeks. The GC, on a project that had experienced substantial overruns and had finished 10 months late, had submitted a final reconciliation of allowances. One of these allowances had overrun by $80,000 on a $210,000 allowance. The GC had offered, as proof, a stack of T&M tickets submitted by the subcontractor that performed the allowance work. When we added up the stack, the amount only came to $80,000 not the $290,000 as expected. When questioned, the GC said that the original subcontract amount had included all of the original allowance scope and that the T&M tickets only related to changes in the allowance scope. Although the audit trail was very sketchy in this regard, there was one interesting item; a $150,000 credit change order was written to this same subcontractor with no backup to indicate why. The explanation given by the GC was that the credit was a voluntary credit offered by the sub, essentially after the contract was complete, for a bid duplication. Some of you have probably been around longer than we have and may have witnessed such an event. We however, have seen a sub offering to pay for lunch when a job has
gone well, but on a job that lasted 10 months too long, a sub with a lump sum contract, in this market, volunteering a $150,000 credit for no reason? Of course, the credit could have had something to do with the allowance that was "bought out", but no, because that would mean that the GC was not telling us the truth.

THE FEE IS JUST THE BEGINNING

In a meeting a few weeks ago, the former head of one of the largest Construction Managers told a group of businessmen, "CM charges for insurance, Subguard, and purchasing had contributed to 60% of the overall profits of the company." Are you surprised?



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INSIDE THIS ISSUE

FURTHER PERILS OF ALLOWING SELF-PERFORMED WORK

Over and over we see a GC abusing the Owners trust when the Owner allows the GC to self-perform work. We could easily fill up this newsletter with just the last month's stories alone, however we try to resist, unless, of course, there is a really great abuse to note. So, on a recent $40 M project in the Midwest the GC had asked to bid some of the subcontract work. In this case, they turned in prices for Drywalland Concrete. This GC was in charge of soliciting the sub bids and tendering a bid tabulation sheet to the Owner. The GC was apparently low on both scopes of work and the Owner allowed them to proceed to do the work as if they were the subcontractor. After the project was over, the Owner learned that while the GC showed the Owner two sub bids for Drywall, in addition to their own, there were actually three subs bids. The lowest sub bid was not disclosed to the Owner and the GC actually subcontracted the Work to this sub and pocketed the difference. In this case, the difference was $700,000. As to the Concrete work, the GC showed the Owner two sub bids in addition to their own, as well. The Owner later discovered that only one concrete sub bid the work, and that the other sub bid was entirely fabricated. The GC, by soliciting and obtaining one sub bid for this major scope of work, only had to undercut one sub to show a savings to the Owner. The GC pocketed an additional $400,000 on this scope of work.

RECRUITING CHARGES

On a recent audit of a project in the Northeast, we noticed numerous charges to job cost for recruiting costs or headhunter fees. On this project there were our charges total, for employees that were hired at the beginning or during the project. Two of the charges indicated a recruiting agency payee, while two of the largest entries that came to $37,000, did not. Now you probably can guess that we had no intention of allowing such costs, which are nothing more than outsourcing of home office overhead, but we asked to see the invoices that supported the costs anyway. In this instance the two "invoices", that had no payee listed, were internal generated items. The GC had actually used its own human resources department to find these employees but had decided that the Owner needed to contribute to overhead by calling this a cost and creating an invoice. We respectfully disagreed.

PROBLEMS WITH ALLOWING FIXED HOURLY RATES FOR SALARIED EMPLOYEES

Every Owner knows that salaried employees do not get paid by the hour and yet many times an Owner agrees to an hourly fixed reimbursable rate. The problems with this approach are as follows (in no particular order).

- The fixed rate could be higher than actual cost (and almost always is). Our measured rule of thumb is 20% to 25%, generally.
- The GC could bill based on hours worked vs. hours paid, even though the rate was developed using an assumption of 40 hours in a week. This scheme could generate an additional 10% - 15% (in case you are keeping score).

- The rates could be based on subjective job titles and therefore very difficult to enforce. This week's project had a PM (that was the title on his business card) charging as a Sr. PM. The rate difference between one and the other was 15%. On a past project we audited an Architect that employed the same thought process and overbilled $2 M on a very large forced remodel (earthquake damage).
- The contract may not be clear as to what is included in the rate. Is vacation and holiday time in the rate or outside? Are bonuses, of all kinds, included? What about car allowances? What if one person elects to not get a car allowance but a company car instead? Is the company car also included in the hourly rate, in this case? The potential duplicate billings for vacation and paid time off can increase the amount collected vs. paid by 10% - 15%.

Our solution is to not agree to hourly rates for salaried employees and reimburse actual cost instead. Alternatively, an audit of the rates in advance is always advisable, with care to include a clear list of cost items included in the rates in the contract, a list of persons that should be assigned to each category, and a provision that total weekly billed hours cannot exceed 40 hours times, hours worked divided by hours worked and paid. For example, when an employee works 50 hours in a week and is off on Friday for Holiday, the calculated hours allowed to be billed, of a full week (40 hrs.) salary, would be (40 X (50 / (50 +8) = 34.48 vs. 50.

ANOTHER REASON TO BE CONCERNED ABOUT CONSTRUCTION MANAGERS USING SUBGUARD

On two separate projects, with different GC's, we have recently seen another kind of issue that should make SubGuard problematic for Owners. On these projects the GC had billed the Owner for SubGuard, collected the premiums, had four subcontractors' default (two each job), and refused to file SubGuard claims. On both projects, these sub defaults caused or contributed to extensive delays, of which SubGuard should reimburse the GC for, in theory. However, given the GC's self-insurance portion of SubGuard, the GC could potentially be out more than a $1 M per claim, after deductibles and coinsurance. This surely contributed to these GC's deciding to claim that the Owner or the Architect was the true cause of the delays and therefore their refusal to file a SubGuard claim in the Owners and the Projects behalf. These examples are some of the truest explanations of why we do not see SubGuard as an Owner protection instrument. If bonds had been procured, possibly the bonding company would have made a case that some of the claim events and delays were not their subcontractors doing, but a claim would have been filed and the GC would have been on the Owners side in such a case. To add insult to injury, in both of these cases, the GC talked the Owner to paying the GC more in SubGuard premium than sub bonds would have cost. Don't say we did not warn you.

WHEN THE OWNERS DEVELOPMENT PARTNER IS ALSO THE CM/GC

We have audited several projects recently where our client had a partner that acted as development manager and also the GC. You can already imagine the possible conflicts of interest that could develop as one partner trusts the other partner to manage the development of the project and that partner employs an in house or affiliate to estimate and build the building. Yes, everything you can imagine was present in our last three audits with this type of arrangement. On a project last month, the development partner agreed to a savings bonus with it's in house construction company. When we audited the final cost we saw that there was over $1.2 M in savings on a $25 M project, which the GC kept $400,000 as its shared savings bonus. After investigation, we determined that $1 M of the total savings was generated by the GC not using the low steel bidder in it's GMP estimate and then promptly (in fact prior to the contract date) subcontracting with the actual low bidder.

Did the development partner know of the true steel bid or were they lazy given the possible trust they had in their own company? We do not know, but this same lackadaisical oversight is common with this arrangement. Also common is a development partner that refuses to, or cannot for internal political reasons, hold its contracting arm accountable when it is needed, against both Owner partner's best interests.

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INSIDE THIS ISSUE

AUDIT CONCERNS IN A SHRINKING CONSTRUCTION MARKET

It has been quite a few years since we have gone through a construction downturn like we are seeing currently. Over the last 10 years most of you have been more concerned with getting good people and adequately supplying the projects with materials and equipment. Some of you may recall a time when we worried about GC's parking employees on our jobs and leaving rental equipment on the job idle while continuing to bill us, the Owner. Well it seems as if some of those days are here again. We wrote recently about trying to limit GC employee bonuses and raises on GMP projects. The number of GC employees and quantity of equipment should be added to that list as well. If you have a project that also has GMP subs, these same issues apply to them.

Owners on most large projects have been given an estimate of General Conditions complete with man loading charts or schedules. We suggest dusting that document off and reviewing your current management man loading against the original estimate. Significant deviations in manpower may signal an issue to be discussed with your GC.

Equipment "parked" on your project may be harder to evaluate, especially if, as an owner, you are not present on the job site every day. On one of our projects 15 years ago, we would put small stones on the tires of some of the larger equipment and, days later, saw if they were still there. You may have also received an equipment loading schedule or an estimate of equipment costs that could be deciphered to show what equipment was anticipated and the durations of each. Looking at this document may prove to be worthwhile.

One of our Owners on a large project in the Northeast recently recounted the GC's management openly discussing "fee enhancement" as if it was an approved concept. In this light, another possible GC response in a declining market is to be more aggressive in trying to self-perform work at an additional fee. Any attempt by a GC to self-perform work is potentially problematic for the Owner. Any Owner has a right to be concerned about the true competitive nature of the bid process and, after award, if self-performed costs might happen to be comingled with cost plus costs.

Lastly, on new projects we have already seen some stated GC fees coming down. Regardless, expect those same GC's to be doubly aggressive in trying to get the Owner to agree to fixed labor rates, fixed burden rates, fixed GL insurance, or fixed anything that will add to fee. Of course, you know better than to agree to fixed rates, right?

It is said that opportunities exist in declining markets, we just don't want one of those opportunities to be you.

CONSTRUCTION CONTRACT TERMINATION ISSUES

Not since late 2001 and early 2002 have we seen the amount of activity in projects being suspended or terminated prior to completion. This amount of activity is partially due to economic issues but also, we have seen Owners changing direction due to opportunities to purchase already developed properties. Regardless, because these situations do not occur frequently, many Owners (and some GC's) are not sure how to handle the contractor and subcontract credits that should result from such a change in direction. Basically, in a termination, the Owner typically has two choices; 1-A credit

change order for the deleted scope of work, or 2-A final settlement based on the Termination for Convenience language in the contract. I am sure many of you are not aware that these two methods may deliver different results. Obviously, there is a danger in simplifying the termination process, and also each construction contract can be drafted differently. Here we will attempt to discuss the most commonly seen issues with the hope that something similar may apply to your situation. The first situation would be a credit change order given to the GC, and the GC to their subs, for a deletion of the work that will not be performed. Many construction contracts require a credit for the deleted scope, but not a credit for the fee (Overhead and Profit). As you know, many GC's and subs also do not readily credit bonds and insurance as well as fee, even though the standard AIA contract only indicates that fee should not be applied.

In the situation where the credited scope is substantial, the lack of a fee credit as well can be very large. If we had a contract where the total contract value of the deleted scope was $50 mil., the lack of fee credit from subs could be 15% or $6,521,739. The AIA A201 agreement 14.4.3 states that the Owner owes the Contractor: "actual reasonable costs of the Work executed and a reasonable fee on the Work performed." The later requires the Owner to pay the reasonable actual costs of the Contractor or Subcontractor and some reasonable markup for fee, but not the total fee originally anticipated. The difference can be extremely large. If you have one subcontract of $5,000,000 where the sub has only incurred $150,000 in cost, and assuming a 15% fee, the first method would result in a credit due of $4,197,826 ($5,000,000 minus $150,000 + $652,174 total fee). The second scenario would result in a credit of $4,827,500 ($5,000,000 minus $150,000 + $22,500 fee at 15% of $150,000).

Another nuance in the whole Termination for Convenience credit due calculation is the concept of reasonable cost incurred or executed. We have had meetings with Contractors where their definition of cost incurred by a subcontractor is what the sub had billed them. A sub may have billed for mobilization, bond, insurance, and engineering based on a schedule of values, but that does not mean that the costs had been expended or that the subcontractor's costs equaled the billings. Again, on large subcontracts the difference between the billed and the actual amount.

Sometimes we have seen contracts that allow an Owner to get an "equitable" fee credit if the value of the deleted work is 20% or greater. In this case, the fee credit due could vary by subcontractor, given that the Owner contract language is almost always incorporated into the subcontracts. Some of our Owners have negotiated their construction contracts such that credit change orders, of any amount, should have deductive fee. Just because this language is in your contract do not assume that the GC and subs will voluntarily price their change orders to comply.

The second possibility for an Owner is a Termination for Convenience. Here too the language may vary in your construction contract. The standard AIA language, A201 Article 14.4.3, states the contractor is "entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed". This is the same as saying that there is no credit fee on the value of the deleted scope. However, we have seen many Owners and Contractors who have modified the Termination for Convenience clause to allow the Owner to only pay incurred amount can be great and typically would be only proven during an audit of the costs. A recent audit of the costs incurred by one sub not only showed a variance between the billed amount and the cost to be $130,000 (out of a total $500,000) but also revealed that the sub stood to get a bond credit on the deleted work which would reduce the incurred cost by another $30,000. These results were discovered during a four-hour audit of the subs costs. Sometimes we are asked about our interpretation of the right to audit clause in the construction contract and if that provision applies to subcontractor and suppliers as well.

We always say that we believe that any provision in our GC contract that is incorporated into the subcontract should also apply, including the right to audit. In the case of a termination, you can see why we would need the right to audit cost to determine the final cost due to the sub. We hope that not many of you are put into the situation of needing to negotiate these types of credits, but if you are, we want you to be armed.

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INSIDE THIS ISSUE

IS THE CM'S TOTAL FEE EARNED WHEN TERMINATED AFTER PRECONSTRUCTION?

This question came up the other day and the answer may surprise you. While the AIA121 /CMc contract is not completely definitive, one interpretation of the basic language is that the CM may be entitled to the full fee if the contract is terminated after the preconstruction services but prior to any actual construction. While articles 2.2 and 2.3 clearly indicate that there is contemplated to be a Pre- construction Phase and a Construction Services Phase, it is not indicated clearly that these are separate contracts, and if the Owner desired to terminate the CM after the preconstruction phase, such termination would not allow the CM to collect (the AIA A201 Article 14.4.3) "reasonable overhead and profit on the Work not executed". Such work not executed could be interpreted to be the Construction Phase work. We would strongly recommend that you review these provisions in your basic contracts and see if the above concern has already been addressed. If it has not, we would recommend that a provision be added that allowed the Owner to terminate the CM's contract after the Pre-Construction Phase with an "agreed to" final compensation.

AUDITING THE CONTRACTORS SUB BIDS PRIOR TO AGREEING TO A GMP WITH A SHARED SAVINGS

Many of you are negotiating contracts with a shared savings clause. Often we have seen Owners overlooking a couple of key protection points in these contracts. First, is there a limitation on the total amount of savings subject to sharing? This limitation can be expressed as either a percentage of the Cost of the Work or as a fixed dollar amount and doing so may avoid a windfall bonus payment to the GC. Second, has there been a thorough review of the Contractors estimate including reviewing the subcontractor bids? We had a recent project where the CM manufactured $400,000 in savings on a $3,500,000 project by just padding each sub bid. The Owner believed that agreeing to the GMP, after all of the sub bids were in, protected them against an artificially high estimate. In this case, having the bids ensured that the CM knew how much buyout savings they would have and locked in the savings sharing bonus.

HAVE YOU AGREED TO BONUSES FOR CM EMPLOYEES?

Over a long flight, we had the opportunity to read a current newspaper article concerning a survey of US companies' expectations for the upcoming year end and 2009, as to employee compensation increases, bonuses, and health care benefits. These surveyed companies indicated that expected pay raises would be lower to 3.5%, 62% expected bonuses to be the same or lower, and 25% said that they were increasing the employee's contribution for health care.

We know many of you have locked in labor rates for salaried employees that included bonuses, yearly increases, and company contributions based on past history and that renegotiating these deals for projects that have already begun may be very difficult. For others, your contracts may indicate a reimbursement of actual labor costs and benefits, including

bonuses to be paid with your prior approval. We also know that one of the concerns when entering into a GMP or Cost-Plus contract is the lack of contractor incentive to save the Owner money. This same concern exists when a CM knows that employee bonuses are going to be reimbursed by the Owner. The GC is possibly inclined to build up good will with its employees at the Owners expense.

We have already seen very large CM's laying off employees and started hiring freezes in certain markets. We expect that trend to continue, including all of the cost factors indicated in the survey results above. We recommend that you have a conversation with your CM about its reimbursement expectations for labor cost increases, including bonuses, in the coming year. If your CM acts like it is business as usual and that there has been no negative economic effect on them, you may want to clearly explain what your company's economics are like and what your expectations are.

A LITTLE DETAIL NEVER HURTS

If we had to rate the ways that you can be overcharged on a GMP contract, not getting sufficient detail in the pay the application process has to be near the top. One place where a CM will almost always try to get by with little or no detail is with its labor costs. Commonly we have seen all salaried labor lumped into one account with no employee names, employee hours, and no actual cost per employee. We had the fortune to review a project recently where the CM made a $400,000 "mistake" in its salaried labor billings in one month. You have already guessed if this mistake was in the CM's favor so there is no need to discuss that, but one key ingredient that allowed the CM to be successful (for a while) was that very little detail for labor costs was provided by the CM to the Owner. A CM should be able to provide the detailed support for every charge every month. At a minimum, this support should include employees' names (so we can tell who is being billed to the project), the employee hours by work week (so we can tell if Sam is billing us when he was on vacation last month), and gross labor cost by work week (so we can tell if Sally's bonus is being charged to us).

YOU CAN'T HAVE OUR JOB COST REPORTS

The situation is as follows; you begin a project with one of the largest CM's in the nation, you start getting pay applications with all of the billed amounts supported by copies of invoices, everyone is playing nice together, and then you ask the CM to give you a copy of their job cost report. "We cannot give you that", is the CM's answer, "it is proprietary". Let's examine this perplexing situation. First, what is a job cost report and why did you ask for a job cost report to start with? A Job Cost report is a report common to almost all GC's (by almost all we mean 99.99%), where job costs accrued and incurred are kept separate from those costs incurred on other projects. These incurred costs are entered the job cost by a variety of means, with accounts payable, payroll, and journal vouchers the most common. As costs are entered through each of these systems the CM's overall accounting system is monitoring the inputs to verify amounts, invoice numbers, employee names, etc. and look for duplications and input errors of various kinds. Having a job cost report to review does not eliminate overcharges but gives some safeguards on certain errors such as invoice duplications, voided invoices and false payees. In fact, a recent subcontract audit found $500,000 in duplicated invoices billed on a $7,000,000 subcontract where the subcontractor said that they had no job cost system. They did, and the duplicated billed invoices were not in the job cost report twice, so, getting a job cost report would have shown that job cost and cost billed were different.

Next question is; are these types of reports proprietary and why would a CM not want you to see it? We think we answered the latter question above, but the basic answer is that there is something in the report that the CM does not want you to see. Credit invoices never included in the billings is one common reason for hiding a cost report. Cost billed that is different than cost accumulated in the cost report is another. So is a report that 99.99% of all CM's have, proprietary? Typically CM contracts do not define such a term (which legend says was invented by a CM to keep an Owner from seeing actual cost) but regardless, a CM should be required to keep full and detailed accounts and exercise controls as may be necessary for proper financial management under the contract and the accounting and control systems shall be satisfactory to the Owner. The last phrasing comes from the AIA standard contract. Giving the Owner access to the billed invoices does not ensure the proper accounting and control systems required by the contract. Only the CM's own job cost system does that and is therefore required if an Owner wants to avoid a host of incorrect charges.

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WHAT DO WE AUDIT IN A GMP CONTRACT?

The simple answer is that we review both the calculations that have led up to the final contract value and the reimbursable cost and fee calculations that must be compared to the final contract value to determine the ultimate lower cost to the Owner.

Sometimes, as we describe the various audit exceptions, it can be confusing whether an exception is ultimately affecting the calculation of the contract value or the reimbursable cost and fee. We have also, over the years, had Owners question the relevance of a contract value exception when it appears as if the contractors cost plus fee would be higher than the contract GMP. One of the reasons that many Owners become confused as to how to interpret the audit exceptions is that many Owners, as the project progresses, pay interim pay applications, at least in part, from a schedule of values presented by the GC. In that situation it appears as if credit adjustments to the contract value and credit adjustments to billable costs have the same effect, lowering the interim billings. However, at the end of the GMP project, the Owner is typically going to pay to the contractor the lower of the adjusted GMP or the cost plus the fee. So, when the project has ended, the audited final GMP and the audited final cost and fee must be determined to see which is less. Hopefully, in an attempt to clear up the possible confusion and to give examples of what typical audit exceptions are, we offer the following discussion:

AUDITING THE GMP AND TYPES OF AUDIT EXCEPTIONS: We refer to the audit of the calculations that make up the final GMP contract value as Auditing the GMP. When auditing the ultimate contract value there are many items to review. The most common areas are making sure that the change orders have been processed and calculated per the terms of the contract and that allowances have all been reconciled properly. When reviewing the change orders we want to make sure that markup's and fees for both subcontractors and the GC have been calculated per the contract and that all scope deletions have a corresponding Owner deductive change order. An example of some typical markup audit exceptions would be; 1, where the GC did not net additive and deductive change orders when adding fee if the contract requires them to do so; 2, where an allowance was not reconciled and that the actual cost to the GC was less than the allowance amount, or; 3, where the GC took a credit from a sub for a scope deletion but that same deletion was not processed to the Owner. All of these types of exceptions would serve to reduce the final GMP amount while not necessarily effecting the contractor's actual reimbursable cost.

Because of the nature of GMP contracts, these previous audit exceptions would be identical if there was a GMP contract or a Lump Sum contract. Sometimes, if the GC has reported that their cost plus the fee is significantly in excess of the contract value, and once we have verified that that situation does indeed exist, we will focus totally on the audit of the GMP and not spend any time further on the reimbursable cost. We have seen situations where the GC knew early in the project that the actual cost would exceed its estimated cost. This situation could cause the GC to look for ways to increase the contract value more than allowed, or not decrease the contract value as much as required. We often have substantial GMP audit exceptions in these instances partially due to this predictable GC behavior.

AUDITING THE REIMBURSABLE COST AND FINAL FEE CALCULATION: Auditing the reimbursable cost is what most Owners think of when an audit is performed. Approximately 70% of the contracts we audit have some type of contract savings, meaning that the reimbursable cost and fee is ultimately less than the adjusted GMP contract amount after

change orders. In these circumstances any cost that the GC has included in the Cost of the Work, that is found to be not reimbursable, will lower the ultimate final cost that the Owner owes to the GC. Examples of typical cost or fee calculation exceptions would be: 1-Home office employees charged to the Cost of the Work, 2-Labor burden payroll taxes in excess of actual payments for same, 3-Cost charged for GC owned equipment in excess of fair market value, 4-Subguard cost charged on estimated subcontract amounts rather than on actual final subcontract amounts, and 5-Fee only added to additive change orders and not credited on deductive change orders.

Because of the nature of GMP contracts, the above reimbursable cost exceptions would be identical on a Cost plus a Fee contract with no GMP. In a situation where the GC is in a significant contract savings and there is no savings bonus given to the GC, we will often focus almost solely on the examination of the reimbursable cost. In situations where the GC knows that the estimated cost is significantly greater than actual cost and has been allowed to bill off a schedule of values or has not been providing full actual cost backup in the billings, we have seen variations between cost billed and actual cost greater than $1,000,000.

FINAL AUDIT RECONCILIATION: At the conclusion of the audit, a final contract reconciliation is needed to determine if the final audited contract GMP is less than the audited reimbursable cost-plus fee or visa versa. Typically, an audit report will contain both types of exceptions, audit adjustments to the contract GMP and audit exceptions to the reimbursable cost and fee. As you can see from the discussion above, one type of exception is not the same as another. This is why we separate the two types of exceptions in our audit reports, so they will not be confused with each other. We hope this discussion makes the process a little clearer and helps you interpret our audit reports, short of asking us, of course.

SOME NEW CCIP OVERCHARGES

CCIP, or Contractor Controlled Insurance Programs which typically include GL, Excess Liability and Workers Comp. insurance, have become almost as widespread as Subguard. Why you ask? There is money in it, for a start, and if you are involved in a residential project some types of insurance may not be readily available to many subs, causing an Owner to have to either consider a CCIP or an OCIP. We would like to deviate from the question of whether CCIP's are a good idea on your nonresidential project (often they are not a bargain at the price you are asked to pay) and discuss some other creative ways a GC can increase cost to the Owner in CCIP's.

One creative overcharge involves the GC including the agreed to CCIP cost in subcontract values and including it as a line item in the schedule of values. The GC adds a percentage to the low bid sub's price for the CCIP insurance that is actually being purchased by the GC. The GC has no intention of paying this amount to the subs, it is just less obvious to anyone that may look at the billings. The Owner is then asked to pay the GC upfront most, or all, of the CCIP amount. The Owner is not aware that the GC has included a similar amount in the subcontracts as well. The GC then requires the subs to bill all of this extra insurance in their first pay application. The GC collects this insurance amount from the Owner in addition to the CCIP amount disclosed in the pay application, pays the sub only the subs actual cost, not the CCIP amount that the sub was asked to bill, and therefore collects twice, or close to twice, the CCIP estimated amount from the Owner very early in the project. If the Owner catches on at the end of the project then the total CCIP cost is reconciled, but of course the GC has had the Owners money for a year or more. If the Owner does not catch on and there is no audit performed, then…. well you get the idea.

A second issue is requiring the subs to provide proof of additional insurance. The main point here is why the Owner agreed to CCIP in the first place. Many of you have heard the GC spiel of why CCIP's are a good thing for the Owner. A single source of insurance for all claims, less cost, and finally, better coverage than many subcontractors can afford, thereby allowing smaller, and possibly advantaged, subcontractors a more realistic opportunity to bid on work. On this last point we have seen recently where smaller subs who did not meet the GL requirements of a certain GC were required to buy insurance at higher limits. This additional insurance was then added to the subs bid, thereby increasing the bid and increasing the cost to the Owner. Now, tell me again why we are letting a GC charge us for CCIP's?

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INSIDE THIS ISSUE

"MUTUALLY AGREEABLE" AUDIT FIRM

We have all heard of "code" words and phrases that say one thing but mean something entirely different. To this list, we respectfully offer the newest code Audit Firm phrase, "mutually agreeable audit firm". Given the forum here, perhaps you can guess what "mutually agreeable audit firm" actually means. Recently, a large software company asked for our assistance in auditing their contractor on a large and interior finish project. Their contract with the contractor contained an audit provision that provided that the contractor and Owner would agree on a mutually agreeable audit firm. When the Owner told the contractor that they had hired CCM Consulting Group as their audit firm, the contractor informed them that CCM was not acceptable and that they would only agree to certain auditors. The agreeable audit firms had one thing in common, they did not specialize in construction auditing and they had never audited this contractor.

If the contractor had allowed an experienced construction auditor chances are they Contingency would have been a company that had audited this contractor many times. If they had audited this contractor many times they would know where to look. We are sure that the Owner did not contemplate that they could not hire the most experienced audit firms when they agreed to such contract language, but perhaps they now know the code. So should you.

SUBGUARD AND PAYMENT AND PERFORMANCE BONDS

SubGuard use has become ubiquitous by major contractors on projects. However we are seeing something else commonly used by these same contractor's; payment and performance bonds. No, we are not talking about, either bonds or SubGuard, we are talking about billing the Owner for both at the same time.

Recently we audited a project where the contractor had charged the Owner 1.2% of subcontract value for SubGuard as well as including the actual costs of payment and performance bonds in the subcontracts themselves. At first the contractor indicated that they only bonded certain high-risk subs. Later they said that the contract did not specifically forbid them from purchasing bonds. When they finally realized that we were going to discover that all subs were bonded they agreed to back out the bond premium cost. On this particular project, the double charge was $450,000.

WHEN IS A LEASE NOT A LEASE?

Most of us are familiar with leases available for the family car. For this reason, when we hear that a contractor has leased its trucks and that we are being billed the "actual" lease cost, a typical Owner does not see any problems. Not so fast Bunky. What if you found out that the "lease" was just a creative financing arrangement where the full value of the truck is amortized over the lease term and that while the title never actually goes over to the Contractor, when the truck is sold the sale price proceeds are deducted from the Contractor's next lease bill. In this situation the lease payment is no more actual cost than a truck payment to some bank. The real cost of the truck, for reimbursable cost purposes, is the depreciated value of the unit, not what the contractor is calling the lease payment.

IMPOSSIBLE TO TELL

It appears as if the larger the contractor the harder or, if you buy the contractor's story, impossible it becomes to tell what the true cost of insurance is. Now if you are a contractor and you can't prove the true cost of general liability insurance you have a potential problem. OK, let's be truthful, the contractor has a darn good idea what insurance costs. It's just that charging actual costs leaves a lot of money on the table.

Your contractor is good at math, audit math that is. Typically, only 10 projects out of 100 are audited. Perhaps only two or three out of 10 are audited by experienced construction auditors. So out of 100 projects, they only have to actually justify their true costs of general liability insurance on 2 or 3. Assuming that the contractor has overstated the actual cost of general liability insurance by double on all projects and has had to charge actual costs on only 3%, it just doesn't make sense to charge actual cost.

Of course that doesn't mean that the contractor is going to roll over and allow the Owner an easy way to deny their billing of 1% or so for general liability insurance. What we have seen recently is a new tactic. Don't let the auditor see any backup for insurance. At first this seems a bad strategy, after all if they won't document the true cost then the Owner can deny the billing in full. However, some contractors have seen that many Owners are willing to negotiate a cost for general liability insurance. If the contractor had shown the auditor, the full documentation for actual cost then the Owner would only pay actual cost. On the other hand, if the contractor refuses to show the backup then they have the opportunity to negotiate a better deal. Worst case for the contractor is that the Owner is only willing to pay, based on the auditors' recommendation, a sum that is at or less than actual cost. If the Owners offer is less than actual cost the contractor can always change their mind and allow the real costs to be revealed. The end result is that some of these contractors have figured a way to collect more than actual costs, even when they are audited and the contract has a strong audit clause, by refusing to cooperate. Is this a great country or what?

SAVINGS SHARING ON CONTINGENCY

Many of you enter into negotiated GMP contracts that have savings sharing clauses. Additionally, many of these contracts have a negotiated amount for unforeseen costs labeled as contingency. Some of you, however, do not indicate that this contingency is not to be considered "savings" for the purposes of the shared savings provision. Recently we had the opportunity to audit two large projects, for separate Owners, where the savings sharing on just the unspent contingency was over $1,000,000 on one and $625,000 on the other. Allowing a contractor, a safety net called contingency is one thing, allowing a potential windfall is something else.

FEE ON CHANGE ORDERS

We have seen a pattern developing where a Contractor inserts a change in the standard AIA 201 language that allows 10% OH and 5% fee on Construction Change Directives. CCD's are typically only used when there is a disputed cost of a change order and the Owner directs the GC to keep a record of the actual cost. Once the GC has gotten this language inserted then they try to markup all change orders, even non-CCD's, using this 10% plus 5%, rather than the AIA Article 5 fee percentage. If you have already had this happen to you, don't panic. One defense is that the CCD language does not apply to non-CCD's. A second defense is that AIA 111 Article 1 indicates that the AIA 111 governs if there are conflicts with the other documents.

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SHOULD LUMP SUM AGREEMENTS, WITHIN THE GMP, BE AUDITABLE?

Of course they should, who do you think writes these articles? But, please consider the following situation and you may agree.

An Owner agrees to an overall GMP with several fixed cost components; general conditions and self-performed concrete work. At the end of the project an audit is performed, and it is discovered that a safety supervisor, small tools, dumpsters, rental equipment, and a MEP coordinator had all been charged to the reimbursable cost of work. The auditor also discovers that these same items are itemized in various parts of the original estimate, including the estimate for general conditions (which is lump sum) and cost of work, as well as a requirement to be provided by the subcontractors bidding the concrete work, which is also lump sum.

In the above scenario, the right to audit the cost charged to general conditions and concrete work would allow the Owner to determine if the GC had apportioned these common costs reasonably or if all these costs had been charged to the reimbursable cost of work. Of course, the right to audit does not invalidate the lump sum agreement. The right to audit just allows the Owner to verify, more easily, that costs are fairly distributed.

You won't be shocked, we assume, to learn that in this case study, these common costs were disproportionately charged to the cost of work rather than the lump sums. The Owners right to audit gave the GC no valid excuse for the inconsistent charges and a credit was agreed to quickly.

WHY DID WE ASK FOR LABOR RATES?

Time after time, we get involved with a project where the Owner sends out an RFP which includes the proposed contract, a request for fee, general conditions budget, and asks for the GC to include labor rates for salaried personnel and hourly personnel.

Since the proposed contract is a GMP contract with definitions of reimbursable cost, the request by the Owner for labor rate information is informational only. In fact, we have seen many instances where the Owner has indicated that the award would be based on the GC's budget, Fee and qualifications of the contractor's personnel, only. Regardless, invariably we eventually get into a discussion with the successful GC about labor rates included in their bid, and whether these rates are now fixed.

Let us evaluate the process. The Owner asks for a fee. Why? In a competitive market place, it is the best way to determine a market driven overhead/profit/risk percentage. Why general conditions? Different firms address the dilemma of jobsite overhead in different ways. Some companies need more jobsite management, some need less. Often, you will see an inverse correlation to fee and total general conditions cost.

Finally, why did the Owner ask for labor rates? Some possible reasons are:

1. The Owner wanted to understand the reimbursement expectation of the contractor.

2. The Owner wanted to compare labor costs from GC to GC.

3. The Owner wanted competitive pressure to get the best deal possible.

In item #1, if we wanted to know the reimbursement expectation of the contractor, we may have put the contractor before the contract. After all, the proposed contract that went with the RFP defined reimbursable and non-reimbursable costs.

In item #2, we wanted to compare labor costs from GC to GC. If we assume that the estimate of General Conditions costs, required of the various contractors, was sufficiently detailed, then a comparison of Project Management and Superintendent costs can be made without asking for labor rates.

Lastly, assume that we wanted the competitive bid environment to help us get the best labor cost deal possible. Consider that in almost all commercial construction work performed near a major metropolitan area, with contractors from that area, the labor market supply and demand forces have already decided what a Project Manager will make and what benefits they will receive. The bidding of the construction work will not alter the negotiations that have already taken place between employer and employee.

The final question the Owner may ask is, even if I haven't gained anything, have I done any harm? This of course is the real reason for this article. The answer is, yes! The contractor will almost universally argue that the labor rates were given in a competitive environment and therefore should be fixed in the contract. Of course the contractor is very aware that the selection criteria were Fee, GC's and personnel, not labor rates. In fact, because all the bidding GC's know that fee and GC's are the only items that actually need to be competitive, often we see the proposed labor rates inflated with the hope that the Owner will make them fixed at some later point or that they can be used to negotiate change orders. So the lesson, class, is, if you must ask for labor rate information, be clear that the request is informational only and rates are not intended to be fixed.

WHAT DOES PROJECT GL INSURANCE COST?

This is difficult question to answer, even for those of us that deal with actual cost every day. The fact that it is a challenge to us, indicates that the average Owner surly does not know. Yet Contractors are attempting, and it appears successfully, to sell project wide GL insurance to Owners every day.

Usually these programs are bundled with W/C insurance as part of a CCIP (Contractor Controlled Insurance Program). Even when they are a part of a total CCIP, the GL insurance portion is typically separately calculated. We recently have worked on several projects where the GC had sold different Owners 2% and 1.5% of contract value for the cost of GL insurance.

So what does project wide GL cost? The answer is that we typically see actual cost of a GC's own GL and Umbrella between .3% and .5% of contract value. We calculated the subcontract GL and Umbrella cost recently on a project in Atlanta at .5% of subcontract value. This .5% of subcontract value equates to approximately .35% of total contract value. Obviously, projects can have their own dynamics and types of construction may vary the calculations somewhat, however, it appears as if project wide GL costs 1% of contract value or less. Additionally, a subcontractors cost of Umbrella insurance typically runs about 50% of the GL cost and is almost always fixed. It is difficult for the sub to justify a project credit for a fixed expense. Therefore, usually we see the actual subcontractor credits, or bid deducts for CCIP projects to be even less than the cost calculated above. Bottom line, if the contractor wants to charge more than .8% of total contract value for project wide GL and Umbrella, the cost may be too high.

"Bottom line, if the contractor wants to charge more than .8% of total contract value for project wide GL and Umbrella, the cost may be too high."

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WEBSITE UPDATE

We decided to finally bring our web presence up to date. You can access all our past newsletters, complete with index, from the last ten years at www.hpmleadership.com/service/audit-contract-services/. There is also a list of services we offer in case you might think we can be of service.

CONTRACTOR CONTROLLED INSURANCE PROGRAM COST

Recently we have had the opportunity to audit three large national contractors that are offering very similar CCIP programs to project owners. These programs essentially are sold as an insurance cost pass through. The contractor indicates that the cost of the insurance program will be the same as the cost that subcontractors would have charged. While the cost would be the same either way, the contractor contends that the coverage will be more complete and there will be only one insurer to deal with if a claim was to arise.

Determining that the credits received from subcontractors are tabulated properly and that the total of these credits are the same as the contractor's charge for the CCIP program is not as easy as it sounds. We are paid to be skeptical of contractor claims and worry that the apparent credits from subs may be manipulated. After recently visiting a subcontractor that has been involved in several of these CCIP programs with several different contractors it appears as if some of our skepticism may be well founded. This subcontractor indicated that recently they had turned in a bid with insurance of approximately $1,000,000. The insurance credit offered was $50,000, making the net subcontract bid of $950,000. When the subcontract was issued to this subcontractor, they were confused by the fact that the gross subcontract was $1,050,000 and the CCIP credit was now $100,000. While the net subcontract amount was still the same amount of $950,000, the changed items did not make sense to the subcontractor.

Unfortunately, the scenario does make sense to us. It appears as if the contractor is trying to justify a higher cost of insurance to bill the owner. Assuming all things are equal, the contractor can make more money on the CCIP program by increasing the apparent cost of the subcontractor insurance. Unless the owner inspects the original sub bids, this sort of deception is hard to detect.

SUB BIDS ARE NOT ACCOUNTING RECORDS

We thought it would be appropriate to segue to an owner's right to see the subcontractor bids. In our previous article, the ability to see the sub-bids is vital to determine if the sub-insurance cost is calculated properly. In a recent audit of a contract using an AIA contract, we had requested to see a certain sub bid to determine if the sub had included overhead doors in their bid that was used in developing the GMP. The contractor told us that they would not make these records available because they were not "accounting records".

What do “accounting records” have to do with an owner’s right to audit? This is where the contractor was trying to get creative. The paragraph in the AIA contract giving the owner the right to audit the contractor’s records is titled “Accounting Records”. The contractor we were auditing indicated that the only records subject to audit, therefore, were accounting records and sub bids did not qualify. While we had never run into that argument before, it does give an owner one more thing to consider clarifying when using the off the shelf AIA forms.

AFFILIATES OF CONTRACTORS WORKING FOR SUBCONTRACTORS

When auditing a recent project in the Northeast, we encountered a situation that we had not noticed previously. The contractor had an affiliate company that performed concrete and general trades type work. This affiliate had some billings directly to the contractor. As you might expect, these billings included OH&P. Now, we see this situation quite frequently but what makes this case unique was not the billings we could see but the billings we did not see.

It seems as if the contractor had made a deal with the various subcontractors, during the bid and negotiation phase of buying out the job, to have the contractor’s affiliate perform cleanup for the subcontractor. We suspect that this agreement increased the cost of the bought-out subcontract. The affiliate then billed the cleanup cost directly to the subcontractors and since the subcontracts were lump sum, we would never see the cost of this related party transaction. We can readily assume that such a scheme resulted in additional profits for the contractor’s parent company at an increase of cost to the Owner. The lesson: a timely review of the subcontractor’s bids may turn
out to be a good idea.

ARE YOU PAYING FOR SUBGUARD AND SUB BONDS?

It is hard to go at least one newsletter and not put in something about Subguard. This time we are cautioning you on the possibility that while you may have agreed to pay for Subguard, the contractor may have also bonded some subcontractors anyway and charged you double. This is what we first found on a project a few months ago and then at least twice since then on different projects in Denver and Boston.

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INSIDE THIS ISSUE

ARE YOU WRITING ABOUT ME?

Every time we send out these newsletters we get a response back from many clients that we must have written a particular article about them. Obviously, we need something to write about, but often the client is mistaken. The reason that many of these situations sound familiar is that there are only so many tricks to be tried and all reimbursable cost contracts are 95% the same. Hopefully, the payoff, from the reading of these updates, is that what we found on someone else's project will save you money on yours.

BILLING GL INSURANCE UPFRONT

The cost of GL and Umbrella insurance has been a subject discussed here for years, however, this time we are going to discuss not the cost but the timing. It seems as if a memo has been passed around among GC's that Owners may be willing to accept the billing of the entire GL insurance cost upfront.

At this point it may be helpful to point out that almost all GC's either pay for GL over the course of the policy period, pay for GL as claims are paid, or both. By billing the Owner upfront, the GC has benefit of the Owners money for a longer period of time and, if it turns out the GC has over billed for the cost of general liability insurance, the Owner must then recover the over billed amount from the GC.

Bottom line is, do not allow the GC to bill the general liability upfront, even if you have agreed on a total project cost for this insurance unless you just enjoy paying more in construction interest.

BILLING FOR MOBILIZATION

Why do we see many GC's billing for "mobilization" at a flat dollar amount in the first billing? The answer is "It works". Owners have a habit of allowing a GC to bill $100,000, or so, as mobilization on the first billing. This mobilization billing will sometimes be in addition to a percentage billing for general conditions cost. Then, starting with the second or third billing the GC will begin billing at actual incurred costs for that month. The problem is that the GC will usually not go back and reconcile the overbilling from mobilization billing in pay applications #1 or #2. Therefore, the overbilling will continue until the Owner has an audit done or never, whichever occurs first.

OCIP CREDITS FROM CONTACTORS SHOULD BE THE SAME AS ESTIMATED COST

insurance credits due from the contractors are reconciled at project completion with the Owner allowing the contractors to include estimated insurance cost in the contract value with a final deduct taken at project completion. Typically, these OCIP's are administered by an insurance agency with assistance from the Owners in-house risk management department. The administrator will be responsible for verifying the credits received from the Contractor and subcontractors for the Owner provided insurance. However, this agent typically has very little contact with the Owners

First, it is not wise to include a best efforts completion date without outlining whether acceleration costs are reimbursable in the contract. Second, the Owner should take note of any excessive overtime and ask who is going to pick up the tab. Third, the contract should state that overtime is not reimbursable without prior approval from the Owner.

project management personnel when it comes to estimated costs and change orders. We have seen, in almost every OCIP project, glaring differences between the credits received from a GC and Subcontractor for OCIP and the estimated cost for the same insurance used in developing the GMP and Change Orders. On a recent project, the difference between the workers compensation and general liability insurance in the GMP developed by the GC and the approved actual cost credit as determined by the insurance agent was $600,000. On another project, a subcontractor was marking up labor on change orders 15% for workers compensation insurance even though the actual cost had been determined to be just 6% by the OCIP administrator. Project management personnel should require that the OCIP administrator's information on actual cost be made available to allow for use in determining the proper estimated cost of insurance.

NOT YET COMPLETE DEDUCTIVE CHANGE ORDERS

We try to put in at least one "you're kidding me!" item in each newsletter. Even though the following is more humorous than substantial, we hope that it will be worthwhile.

While performing a final audit of a large residential project recently, we were reviewing the billings of some of the subcontractors. All of the subcontractors were under lump sum contracts and all were billed almost complete. In fact, several of the subcontractors had billed their "Total Completed and Stored to Date" at amounts in excess of the contract sums. When we reviewed the cause of this situation, we discovered that these subs had many additive and some deductive change orders. Many of the deductive changes related to the additive ones, such as adding 50 light fixtures on one change order and taking away 25 on another. The subs in question had billed their original scope of work 100% complete. They had also billed all of their additive change orders complete, yet for some reason, they were having a difficult time completing the deductive change orders. Had they ever completed the deductive change orders then the final billings would have been less, but since they couldn't quite finish the credit work they were faced with the burden of having to bill more cost.

Of course, if the Owner or Contractor required the subcontractors to incorporate all change orders into a revised schedule of values, this strategy for overbilling would not work.

WHO PAYS FOR ACCELERATING THE SCHEDULE?

In a recent audit the Owner's contract did not specifically address whether overtime was reimbursable. On this project, the contract named a specific date for completion, but also said that the contractor would use its best efforts to achieve completion at an earlier date also named in the contract. There was no definition of what the "best efforts" meant and if the additional costs of "best efforts" were grounds for a change order. The contractor assumed he was authorized to spend whatever money that was necessary to achieve the earliest date named in the contract.

In the end, the contractor essentially achieved the earlier date and gave the Owner a bill for overtime, expedited materials costs, etc. to make the earlier date. The Owner had no idea that this was going on and was astounded at the size of the bill to compress the schedule. As of this writing, the issue is not resolved. We can see the potential for claims and potentially a law suit.

It seems there are at least three lessons to be learned here. First, it does not seem wise to include a best efforts completion date, other than the scheduled completion date, without discussing in the contract whether any additional acceleration costs are reimbursable or create a scope change. Second, Owner's representatives should take note of any excessive overtime being worked and ask who the contractor anticipated was going to pick up the tab. Third, the contract should state that overtime is not reimbursable without the specific approval of the Owner in advance.

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INSIDE THIS ISSUE

WHAT INSURANCE IS REIMBURSABLE?

If you have had the chance to a review a contractors list of insurance items are included in its calculation of the General Liability charge, you may well ask yourself, “Is all of this insurance reimbursable?” The answer is “most probably not”.

For the last 17 years we have seen GL, Excess liability and Auto insurance included in the GL rate calculation. Sometime later we began to see property insurance added, then Builders Risk deductibles and now Fiduciary Liability, Crime insurance, Directors and Officers Liability, Kidnap and Extortion, Employment Practices Liability, Lawyers Liability, Warranty Liability, Owned and Non-Owned Aircraft Liability to name just some.

So the question at hand is “What is reimbursable?” Essentially the answer is, only that insurance that is required by contract and, per the specific terms of your contract, maybe only up to the limits required. An example of the last point is a contract that requires $20 million in excess liability coverage, but the contractor has $50 million in coverage. The contractor is charging you a pro rata portion of the coverage over $20 million even though it is not required by your project.

A contractor may elect to insure its home office contents for fire, or protect the equity of the owners of the construction company from someone in the accounting department wiring money to a Swiss bank account; however, these insurances are not for the protection of your project, not required by your contract, and therefore not reimbursable.

We typically see these extra items adding between 25% and 33% to the quoted cost so you may very possibly be able to reduce your contractors GL reimbursement by not auditing the actual cost of GL insurance but just asking for a list and cost of the insurance charged under the heading of General Liability Insurance.

WHAT INSURANCE ARE YOU GETTING WITH SUBGUARD?

We have now audited perhaps 20 projects in the last 5 years that have had the contractor charge for Subguard. Subguard is that payment and performance like product being sold by Zurich American Insurance Company to contractors. I do not recall one of these contracts that define what specific risk is or is not covered by these Subguard policies. I guess it comes as no surprise that we have now seen our first case where this lack of detail in the contract and understanding between the Owner and contractor has had major repercussions.

The contractor on a $50 million project billed the Owner for Subguard at 1% of all estimated costs of work except for GC’s, fee, and self-performed work. Six months after contract signing one of the contractor’s major suppliers indicated that they could not deliver the product at the purchase order price and that delivery would be delayed by 2 months. The contractor attempted to pass on the increase in cost and schedule to the Owner. The Owner indicated that the increases were not acceptable and further indicated the supplier default should be a Subguard claim.

The contractor, even after billing Subguard cost to the Owner, indicated that Subguard, as purchased by the contractor, did not protect against supplier defaults. As of this writing, we still do not know if the Subguard policy, as purchased,

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includes suppliers even though the contractor billed the Owner as if it did. Had the contract included a sample Subguard policy with the inclusions and exclusions, as purchased by the contractor, the Owner would be confident as to what insurance, if any, the contractor is billing for and paying to Zurich.

YOU ASKED ABOUT SUBSIDIARIES NOT AFFILIATES

We recently got an education about the word "affiliates". We had asked a contractor and the contractors insurance carrier to confirm that the contractor nor any subsidiaries of the contractor were potentially benefiting from the Contractors Controlled Insurance Program (CCIP) or the Subguard program. The contractor had steadfastly asserted that they had purchased a fixed cost plan on both. We got the requested confirmation that said neither the contractor nor a subsidiary of the contractor had entered into any reciprocal payment arrangement with the insurance company. At the projects end, we asked to see certain records that would have possibly indicated otherwise. This is when the contractor finally came clean. When we asked about the previous letters from themselves and the insurance company to the contrary, we were advised that the company that would receive any refunds and savings from the CCIP and Subguard program was not a subsidiary but an affiliate.

SHARED SAVINGS OR CONTRACTORS WINDFALL

We had the opportunity to audit a $25 million project recently where the contractor had negotiated a 50% shared savings clause. Perhaps predictably, the contractor ended up with a savings of $1,600,000. The contractor argued that the savings was a result of hard work and good project management. Review of the records indicates that buyouts of steel and concrete were far less than was estimated. Had the contractor padded the estimate due to worry about future prices or had the contractor seen an opportunity to pad its profits? Either way the Owner could have protected against excessive shared savings bonus by capping the maximum amount to be paid or by not agreeing to one in the first place.

SHOULD YOU ASK YOUR CONTRACTOR TO HELP PREPARE YOUR PROPERTY LOSS CLAIM?

Over ten years ago, after Hurricane Andrew, we advised of the potential problems with having your contractor help prepare your property loss claim for submittal to the insurance company. Now with many of our customers affected by Katrina and Rita, we repeat this concern. Of course, after a major claim event, you naturally enlist the help of a trusted contractor to assess damage and implement temporary measures to mitigate future damage. It is only natural to use this same contractor to estimate the cost to fully repair the property and assist in the verification of the loss to any insurance company. Unfortunately, we have seen that when the contractor is fully aware of the value of the insurance claim, they feel entitled to participate in the possible difference between any estimate and the actual cost of repairs. One contractor indicated that they helped create the insurance estimate and therefore should rightfully get a bonus, in the form of excess billings, because, after all, they created the Owners savings.

We feel that the best situation is when the Contractor does not have any direct knowledge of the insurance claim amount and the corresponding insurance payments and therefore does not feel entitled to over-bill.

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INSIDE THIS ISSUE

TOP LIST OF DON'TS

Writing these newsletters is always a challenge. We try to talk about new things and yet we see a lot of the same issues over and over. Some of these same old issues can be easily avoided and so we lead off with our top list of don'ts.

1. Don't let the contractor bill a GMP job on a percent complete basis. Remember the two O's. Having the opportunity to review cost does not create an obligation to review. Just this last month we again audited a contractor that was billing on a percent complete from a schedule of values. They had just submitted an invoice to the Owner that was overstated by $1.4 million. The project had been going on for 18 months and the average monthly over billing amount was $780,000.

2. Don't agree to fixed labor rates or fixed labor burden rates without auditing the rates upfront and clearly understanding what costs are included. Of course you know that when you agree to a fixed labor or burden rate you are running a high risk of paying too much. If you have agreed to a market fee why pay more than cost for any other element of job cost?

3. Don't allow the contractor to perform any work, even at a fixed price, that is not auditable. We have seen projects where the contractor performed either General Conditions work or some self-performed work at a fixed price without the owners ability to verify that all the costs have been charged correctly. On one of these projects we discovered that much of the self-performed work was actually performed by subcontractors and also billed to cost of work. On another project we eventually discovered that the contractor began billing it's superintendent to cost of work as a foreman. We have also found insurance claim payments going to the fixed price work rather than the cost of work where it belonged. Making all records auditable gives the owner one more chance to make sure costs are accounted for properly.

4. Don't assume the contractor has your best interests in mind when subcontracting. Over and over we have seen contractors including unit prices for labor rates to be used on change orders in subcontracts. Sometimes these rates are obtained at bid time sometimes not, but almost always they are not given any weight in the bid process and are given very little scrutiny to consider if they are close to being accurate. We audited a project where the GC provided some union carpentry labor to the project. The owner had us audit the GC union labor cost in advance. After we had set the rates, with agreement from the GC, the GC's project management agreed to unit rates for a carpentry subcontractor at rates that were 30% higher than the audited rates. Even though the GC knew what real cost were, they still allowed the sub to set rates that were much higher. After all, the Contractor is not paying for change orders.

5. Don't be fooled when the contractor tells you that fixing some element of job cost for billing purposes is easier. Ask yourself, for whom?

SEEN IT ALL

We have been doing this construction audit stuff for a long time, but just when you think you have seen it all, you run into a contractor that is billing vehicle rent to job cost on vehicles they do not own. That's right, the contractor was renting vehicles to the job, four of them to be exact, and they were all owned by employees. But the good part is that the

contractor did not stop there. In attempt to set some kind of record, the contractor also billed subsistence charges (preset in the contract for, we assume, employees that were paid subsistence) for employees that were hired locally and therefore were not paid subsistence.

CAN'T ALWAYS RELY ON POLICY RATES

We have seen some GL insurance policies recently that quote policy rates on rate sheets found in the policy. What is unusual about that, you ask? The rate stated is not the actual rate due to the insurance company. The rate stated actually is both the not subject to losses premium (the amount actually paid to the insurance company regardless of losses) and the subject to losses premium (the amount that may be refunded to the Contractor if losses are minimal). This is just a variation of a high deductible plan that many medium to large Contractors use except for the confusing (on purpose?) rate schedule that makes the cost to the Contractor appear to be fixed, when in fact only a portion of the rate stated is fixed.

SO YOU WANT TO FIX PAYROLL BURDEN RATES

Regardless of what we say, some of you are going to fix payroll burden rates in your contract. If you are going to do it anyway, then be smart and protect yourself as follows:

1.Make sure the contract clearly states what the fixed burden rate covers. Does it cover all payroll taxes, workers compensation insurance and benefits? Do benefits include health insurance, vacation, holiday pay and retirement? Weekly we hear a contractor argue that the fixed burden did not include one of the items listed above.

2. Clearly state whether or not the burden rate applies to overtime. In almost every situation the burden rate will be significantly less for overtime pay. Typically the payroll burden items that do not apply to the premium portion of overtime include, union benefits, workers compensation insurance, general liability insurance, health insurance, and vacation and holiday pay. It is good idea to state that the fixed rate only applies to full time employees who get full time benefits. The fixed burden rate should not be charged on temporary, part time or intern employees who are not eligible for many benefits like retirement, vacation, and health insurance.

4. If bonuses are a reimbursable expense, then clearly state that the fixed burden rate does not apply to bonus cost. Obviously most contractor benefit costs do not increase when bonuses are paid.

5. Make sure that the contract clearly states that the fixed burden rate is applied to base, or taxable, labor cost. We audited a contractor that snuck in the phrase "gross labor" instead of base labor. They then attempted to charge the fixed burden rate on top of labor and payroll burden. A 50% burden rate became 125%.

6. Don't apply one payroll burden rate to both salaried and hourly labor. On a recent preconstruction audit, we found that the payroll burden rate for salaried personnel was 43% and hourly was 49%. Of course the contractor had proposed to charge 60% for both.

7. Lastly, have someone internally or externally, review the proposed rates. Don't think that you can tell what the market is for labor burden rates. Contractors all have a vested interest in telling Owners that payroll burden cost is higher than what it really is. Just because everyone is telling the same story doesn't mean any of them are true.

Make sure the contract clearly states what the fixed burden rate covers, and don't apply one payroll burden rate to both salaried and hourly labor. On a recent preconstruction audit we found that the payroll burden rate for salaried personnel was 43% and hourly was 49%. Of course the contractor had proposed to charge 60% for both.

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INSIDE THIS ISSUE

We were reminded the other day that we had not written a newsletter in some time and that there are those of you that actually read it. Surprising as that might be we decided to start off the New Year with at least one thing accomplished. **We hope that these items will be enlightening or entertaining and for those of you that were contractors at one time but now bathe in the cleansing waters of the** Owners pond, we weren't really talking about you.

WHAT IS THE INCENTIVE?

Over the past 17 years of auditing construction contracts we have learned one lesson well, follow the money. Actually it is a lesson at the heart of micro economics. People will do what they are incentivized to do, not necessarily what their contract tells them to do. As an example, a typical construction contract says that the contractor shall use reasonable care and judgment and shall provide service in the most economical manner consistent with the best interests of the Owner. However, this clause is often ignored when the Contractor is presented with the opportunity of making an extra fee.

Should we be shocked that the contractor may not legitimately bid his own self performed work against others and may use questionable judgment when determining which company was actually the low bidder, themselves or a sub if they had the opportunity to make an extra 10% to 20% on self-performed work? Are we amazed when the contractor really subcontracts out the work they are calling self-performed but still attempts to collect the self-performed fee? Would you vow never to use the contractor again who tries to pass off clean up and dumpster rentals as self-performed work in order to get an extra fee?

- What are some of the incentives that we give the Contractor when we lump sum general conditions cost?
- Limit management employees to the lowest level possible and only place the least costly (i.e. experienced) employees acceptable to the Owner?
- Shift costs and personnel to reimbursable cost of work by calling superintendents "foremen" and requiring all subs to participate in general cleanup crews?

Should you give a contractor a percentage of the savings in the GMP? Sure, if you want the potential for the GMP to be artificially inflated at every opportunity. The only time we have ever witnessed the contractor negotiating the final GMP with the Owner using what was represented as the lowest qualified bidders only to subcontract the next day with even lower subcontractors was when the Owner felt that a 50% shared savings was a good idea. Ditto for the contractor that included 100% payment performance bonds for all subs in the GMP and all change orders, yet the contractor did not bond one single subcontractor.

Do you want to fix payroll burden rates? Be prepared for the contractor that includes union benefits in all of its payroll reports as part of base wage thereby collecting payroll burden more than twice. Or be prepared to argue with the multitude of contractors that include vacation in the fixed burden rate and then charge actual vacation directly the job cost also.

The lesson, we hope, is to put yourself in the shoes of a contractor (with very little ethical baggage) when negotiating contract terms. Given the contract terms that are being implemented, what would you as a contractor attempt to get away

with? If you, upon reflection, feel that the ethical challenge is too great for your contractor then consider revising the contract language that may give them, and you, problems later.

TWO FACED

As can be imagined, we have the opportunity to audit some of the same contractors over and over, sometimes for the same Owner but more often than not for various Owners. During these audits, we will hear sometimes contradictory arguments on why the contract terms really don't mean what they say and how the contractor did not anticipate that the Owner would enforce certain language. We also sometimes are told that certain records do not exist, as side deals with insurance and bonding companies. Recently we came upon one contractor's internal checklist for contract language negotiations that puts some doubt on some of the previous explanations from this contractor.

For instance, on Texas projects, the contractor has always insisted that they do not get any bond refund. Why then is it important for the contractor's checklist to caution its contract negotiating personnel to guard against any Owner audit or entitlement to bond-related refunds?

While many of our clients do not consider employee bonuses or incentive compensation as reimbursable costs, this contractor's checklist states to its employees that if bonuses are not allowed as reimbursable consider classifying them as wages instead of incentive compensation.

Finally, apparently regardless of how the contractor makes payments, if any, to insurance and subguard carriers the checklist directs the contract negotiators to insert in the contract language that Liability insurance and subguard should be billed upfront in total in the first billing.

SHOULD WE AUDIT?

We know that many of you ask the question, what is the minimum contract size that it makes sense to audit? Several of our clients have always audited every GMP contract regardless of size, but we know that some of you typically audit only projects in the $10 million and up range. One element to consider is the minimum cost to audit. Notice we said minimum cost not fixed cost. Because we perform audits on a rate per hour basis with reimbursable travel expense, the minimum cost to perform an audit is usually between 16- and 32-man hours, plus travel if required. While the maximum hours for the same projects may be between 32 and 120 hrs. In the last few weeks, with airfares dropping, the fixed cost of travel (airfare) has been greatly reduced to most cities.

Recently we were asked to audit a $5 million contract. The contract situation in this case was nothing abnormal to make one suspicious. The contractor was one that this owner had used very frequently. In fact we had audited the same contractor for the same owner three times in the last two years. While we did find several items that were similar to the past audits there was one item that did not appear on our audit report that may be telling too many of you.

Because of the small size of the contract, the owner had never told the contractor that we would do an audit at project completion. When we did contact the contractor, it seemed that they were slightly surprised and in fact put us off from performing the audit for several weeks. Once we did show up we noticed that just the week before the contractor had credited the job cost for almost $50,000 for "errors" that they had discovered. These errors included overstatement of W/C insurance rates, rental equipment and labor cost corrections. The threat or realization of an upcoming audit, not the audit itself, had caused the contractor to fix some of the job cost errors. However, the $50,000 by itself more than paid for the audit.

Many years ago, an owner asked that we audit a contract that had closed out and been paid one year before. When the owner contacted the contractor about an audit date the contractor asked if the owner wanted its "savings". The owner without losing his cool said "yes, and how much was it?" The reply was $80,000. When we finally did the audit we discovered that the contract was over billed and over paid by $180,000. Without an audit the owner would have netted $80,000, even though an actual audit turned out to be a good decision.

Hopefully the lesson is that regardless of size the contractor should believe that an audit will be performed. When the contract is closed out the contractor should be required to submit a final accounting of costs and fees in anticipation for an audit. Finally, the owner, with our help, should consider if the minimum audit cost would exceed the probable audit recovery.

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INSIDE THIS ISSUE

All our jobs have the potential for getting a little boring at times. Even the life of a jet set construction auditor could become tedious, except for the seemingly infinite creativity of the Contractors and Subcontractors we audit. Below, we have detailed some especially creative attempts at enhancing profit.

ARE UNION BENEFITS WAGES?

A very large union contractor had negotiated a fixed payroll burden rate for workers comp. ins. and payroll taxes, to be computed as a function of wages. Union benefit costs were to be charged separately at actual cost. Most of you are aware that workers comp. insurance and payroll taxes are paid on taxable wages. For most union hourly employees, the base taxable wage is also their gross wage and deductions for taxes and union dues reduce this gross wage down to the amount in their paycheck. What makes this case unique was that the contractor reported to the Owner a gross wage of the taxable wage and the union benefit. In our case the union worker made $16.50 per hour and the union benefit cost was $9.75. By creatively manipulating their labor reports the Contractor was able to charge the fixed burden rate in the contract on a much greater base labor cost. This amount of creative accounting cost our Owner $300,000 over three projects until we caught it.

ARE YOU CONTRACTING WITH A JOINT VENTURE?

We recently audited a large stadium project where some of the trade work was performed by a joint venture between two large mechanical subcontractors. The contract, in typical fashion, substituted the joint venture name for the subcontractors' name. The interesting part of the story is that when we showed up at the managing joint venture partner's office to perform an audit of the cost of work, we were told that the contract was not with either of the individual joint ventures but only with the joint venture entity. Therefore, we could not see any job cost records of either subcontractor but only the billing files assembled by the joint venture because thos were the only records auditable.

The billing files were merely a listing of all invoices billed by the joint venture. Since we did not have access to the job cost records of either subcontractor, we had no way of proving that the invoices billed were complete (meaning that they might be missing all of the credits) and not duplicated. As to the completeness issue, we found that out of 36 months of billings and thousands of material cost transactions, not one single credit invoice was billed to the GC and Owner. The subcontractor while generally quite bold and self-assured during our audit did seem to be taken off guard when we discovered restocking charges billed with no credit invoices for the materials returned.

At the date of this writing the GC and subcontractor are still discussing our possible lack of audit rights. A simple remedy would be an inclusion of the name of each joint venture partner as a party to the contract and clearly stating that auditable records extend to both parties of the joint venture.

EQUIPMENT CHARGED TO JOB COST WEEKLY AND BILLED AT WEEKLY RATES

To save face when judgment time comes (audit date) a Contractor needs a story any story. Of course, a good one is better than a bad one but any old story will do. So, it is for those Contractors that charge rent for their own equipment to job cost on a weekly basis. At least half of the Contractors we audit, that charge their rental cost weekly, base the weekly charge on the weekly rate found in rental guides like AED. Of course, it doesn't matter that this equipment is rented for months and years at a time and that the same AED guide has monthly rates in addition to weekly ones. In fact, since a rule of thumb in rental rates is that three days equal a week and three weeks equal a month, a Contractor billing all rentals at weekly rates when monthly rates would apply, would over bill one week out of every four or 25%. On a recent audit this exception alone was worth $312,500 to the Owner.

HOW SICK ARE YOU?

Determining a fair sick time burden rate for a Contractor's employees depends on if you are buying or selling. When selling, the contractor will generally state the number of sick days allowed in their company policy per year (usually six or so) and convert the days assumed into a percentage to be applied to base labor cost. Asking the same contractor to document the six-day assumption can be an eye opener. First, our audited average sick days taken by salaried employees of contractors over the last 13 years are close to two days per year, not six. Second, many contractors when forced to show the actual days reported (as opposed to taken) by their salaried job site employees, show reported sick days taken of almost zero.The difference between six days and zero is about 2.5% of base labor. If base labor is $500,000 on your next job you just picked up an extra $12,500 and didn't break a sweat.

TEXAS PAYMENT AND PERFORMANCE BOND REBATE

Texas is unique in how most bonding companies can charge for payment and performance bonds. These rates are established by the State an d little deviation to these State rates is allowed, at least on the front end. After the successful completion of the job many G.C.'s and larger subcontractors receive a rebate, even though we have never seen the rebate passed on to the Owner that paid for the bond in the first place. In the past we have seen this rebate to be 20%. However, we audited a project recently where the G.C. got back 40%! The refund credit of $33,000 was a pleasant surprise to our nonprofit Owner.

DON'T SEND ME THE BACKUP

With good intentions, on GMP projects, many Owners tell the Contractor to keep the backup for general conditions cost but not to send it with the monthly pay requests. We have also seen many situations where the Owner has asked for the Contractor to bill on a percent complete for all costs. Not surprisingly, over the years, these situations have turned out to be the most over billed. One project we audited halfway through had the Contractor over billed by $1,500,000 and had cost the Owner $120,000 in interest at that point. Another recent project had the Contractor over billed by $1,600,000 as of the final pay request. The Owner had only retained $600,000 at this point.

ADDITIONAL FEE FOR SELF-PERFORMED WORK

It has become common in parts of the country to see contractors request additional fee for self-performed work. This trend seems to have picked up steam as contractors that did some trade work began to differentiate themselves

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from those that brokered 100% of the trade work to subcontractors. Of course, the basic arguments for additional fee does contain some logic; an Owner would pay a higher markup to a subcontractor and that there is some additional overhead required in the performance of trade work. Logically, then the reverse would be if work can't be self-performed and does not require additional overhead then no additional fee should be paid. You might be surprised when you ask the contractor to define what constitutes self-performed work.

Recently we have heard a contractor explain that in addition to carpentry they intended to charge a self-performed fee on clean up labor, dumpsters, labor for OSHA protection and weather protection. While this example may seem absurd we have almost never seen a contractor that was given an extra fee on self-performed work separate clean up as a non-self-performed item. Since miscellaneous clean up cannot be easily subcontracted and is not a drain on overhead no additional fee should be allowed, and your contracts should be clear on this point.

SHOULD CONTRACTORS BE RESPONSIBLE FOR ALLOWANCE OVERRUNS?

The basic language in the AIA contracts and most other construction contracts states that allowances are to be reconciled to actual cost by a change order. If there is an overrun the Owner adds to the contract and an underrun decrease the contract amount. Both events are at no risk to the contractor. This especially makes sense when the Owner or Architect establishes the allowance amount or when the scope has not been defined to any reasonable degree. But, should the same hold true when the contractor is the one establishing the allowance amount or if the scope is reasonably defined but the exact cost to the contractor has not been confirmed? Additionally, should the contractor bear some responsibility in purchasing the allowance work as efficiently as possible?

Unfortunately, we have seen two projects in the last couple of years where certain contract allowances where exceeded by many millions of dollars. In some cases, the contractor was aware of the insufficiency of the contractor established allowance amounts prior to contract and yet did not inform the Owner. In another case the allowance work was all done T&M with unskilled laborers, presumably because the Owner would pay any cost overruns.

Next time you are calculating your contract GMP, consider if your allowances are clearly defined as to the scope (labor and material, labor only, fixtures, fixtures and pipe, etc.), are truly unknowns, are clear as to how they will be bought out, and if the scope is mostly known and if the allowance was estimated by your contractor, consider capping the allowance as a not to exceed. If the contractor wants to add a little to the allowance amount to make it a not to exceed, so what. All of the risk in not capping the allowance is on the Owner and if the allowance does actually cost less than a deductive change order is in your future.

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INSIDE THIS ISSUE

HIGHER DEDUCTIBLES

As most of you know the cost of insurance has gone up again. It seems when interest rates and the stock market returns are low the cost of insurance goes up. One of the ways contractors reduce the fixed cost of insurance is to increase their deductibles. Many GMP type contracts include a provision that makes insurance deductibles reimbursable cost under certain circumstances, however we are seeing some of these deductibles in the hundreds of thousands of dollars. This can be quite a shock if there is an insurance loss on the project. This can become a big issue if savings on the project suddenly disappears.

We suggest you review your contract terms to include a limitation on the deductible liability.

REQUEST A FINAL ACCOUNTING BEFORE FINAL PAYMENT

Much of the job of a construction auditor is knowing what to look for or what questions to ask. In fact, one of the most interesting aspects of our work is predicting human behavior and anticipating what conditions must be present for a contractor to overstate cost. All of which leads us to the subject at hand, which is that one of the more frequent overcharges we encounter is that the final invoiced amount exceeds the general contractor's cost-plus fee.

We usually talk about contractors overstating payroll cost or insurance or rental equipment, but we find many times that the contractor just billed more than their job cost showed. Now overbilling can easily occur over the course of a job where an overbilling may have happened in pay application #1 or #2 and was not caught by the Owner. Each subsequent pay application could have been correct, but the error continues right up to the final payment.

Notice, we did not say that the contractor is not aware of the error, yet they have plausible deniability. The general contractor can still claim that they also did not catch the earlier unnoticed overcharge. This is where the requirement of a final accounting comes in. A contractor can blame accounting error or ignorance of contract terms by billing the complete contract value or not correcting some past undiscovered mistake, but can't readily claim clerical error in falsifying a statement of the final cost of labor, labor burden, materials, subcontracts, general conditions, etc. For this reason, we recommend all projects whether audited or not should have a final accounting of costs prepared by the contractor.

Many of you should note that we have advised many owners to obtain a final accounting from the contractor on projects already closed out, final paid and not audited. These final accounting results have recovered hundreds of thousands of dollars for owners in the past 15 years.

CONTRADICTORY EXHIBITS

If you were a contractor looking to overstate reimbursable cost thereby increasing your effective profit margin you live to find contradictions in contract terms. One great place to look is in the difference between the base contract definitions of

reimbursable cost and information included in exhibits. Over the years we have seen; home office accounting disallowed in the base contract and seemingly allowed in estimate exhibits; actual salary and payroll cost as reimbursable one place and fixed payroll rates mentioned in another; limitations of contractor owner equipment rental cost in the body of the contract and opposite language in rental rates exhibits, and list goes on. Also included in discrepancies found in exhibits is contractors unsolicited comments included on exhibits intended for a different purpose, such as statements at the end of rental rate schedule exhibits that fix labor burden and the like. We have even seen a totally different contract made an attachment. If understanding the intent of one contract is difficult enough, how about two?

Obviously, you can see the auditor's dilemma in interpreting these contradictory statements but also think about trying to prove what language governs to a third party, like a judge.

WHAT DO YOU MEAN WHEN YOU SAY "DATA PROCESSING"?

You all know auditors are bean counters. A lumber invoice or a payroll entry are both easy to count. That is until the contract calls for "Cost to be Reimbursed" for subjective items like data processing, or training, or safety. All of these costs can include only the cost incurred on the project site but can also include a company-wide allocation of fixed and variable cost for computer hardware and software, support staff, tuition reimbursement programs for overhead staff and much more. If you were a contractor would you take the narrow view or the broad view in deciding how much to bill the Owner? We have seen amazing creativity from contractors in these areas. One GC in south Florida re-titled its VP of operations as VP of Safety to allow his cost and his department's cost to get billed to projects.
While we love the opportunity to argue these allocations with your contractors, please feel free to make our job less challenging by limiting these subjective costs.

Payroll entry is easy to count. That is until the contract calls for "Cost to be Reimbursed" for subjective items like data processing and/or training. Because these costs can include company-wide fixed and variable cost, be sure to limit subjective costs.

RENTAL EQUIPMENT COST – TOTAL DURATION OR ACTUAL USAGE

A GC has no incentive to overpay a third-party equipment rental company. If a backhoe is needed for four days, it is rented and returned. Now if the backhoe is owned by the GC we might find that it stays for a week or two or much longer, especially if it is not needed urgently elsewhere.

Even Owners that have a daily job site presence may not notice equipment sitting idle for extended periods. Of course, as auditors, after the fact, we might have no evidence at all that an overcharge has occurred. However, occasionally we can pick up on a discrepancy between equipment usage and total duration and recover the owner's money. One recent project returned $110,000 when we noticed that the monthly progress billings for equipment did not match the contractors restated final accounting of equipment rentals based on equipment's total duration spent on the job. We asked the billing clerk why she failed to rent all the equipment that was on her project on a monthly basis and she said that much of the equipment, while checked out to the project was not used and that some of the equipment was actually used on other projects at the same site. Because of the difficulty in tracking this item, we recommend that a log of usage accompany all contractor equipment billings and that the contract state that idle time be paid at a lessor rate or not at all.

CONTRACT REVIEW

As always, we will be glad to review any contract you may be considering. While not a substitute for review by your legal counsel, we are in a good position to spot potential problems due to our extensive exposure to the results of different contract clauses. Please call for further information.

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INSIDE THIS ISSUE

BE ON GUARD FOR SUBGUARD

The partially self-insured competitor to traditional subcontractor bonding called Subguard has really taken off in the last two years. All over the country with contractors big and medium we have seen subguard being pushed. We thought we should give you some advice and some warnings before you let your contractor sell you this particular product. Even though Subguard can be a good alternative traditional bonding and can actually result in a reduced cost to the Owner and the project, because of its very nature Subguard can be overpriced and nothing more than a way for your contractor to make an extra fee. So, what is Subguard?

Subguard is an insurance policy taken out by a contractor or Owner against Contractor and/or subcontractor default. This particular insurance policy has a very high deductible. The contractor negotiates with the subguard insurance company the particulars of the payment plan but typically about one third of the payments made go to the insurance company for the insurance companies' risk and two thirds go into an interest bearing reserve account held by the insurance company in the contractors name. Each contractor is incentivized to over-collect and underpay just like they are if they are largely self-insured for workers compensation and general liability insurance. We have seen contractors quoting subguard payments at 1.75% of subcontractor amounts when the average bond payments would be in the 1% range. We have also seen contractors trying to collect subguard premiums from owners on purchase orders and subcontracts that they never would have considered bonding. We also have seen contractors failing to use their own subguard reserves when subcontractors have defaulted. One recent audit had the contractor replacing a subcontractor after a bankruptcy and charging the Owner $76,000 more for the replacement subcontractor even though the Owner had paid over $500,000 in subguard premiums to the contractor.

We believe that the moneymaking opportunities of subguard are going to be too much to ignore for many contractors. It is up to you as an informed Owner to analyze the subcontractor default risk and negotiate the best price. Additionally, after purchasing subguard you must enforce the terms of your agreement and not let your contractor spend your money to fix subcontractor default problems.

SUBCONTRACTOR CHANGE ORDERS WITHOUT TOTALS

We recently audited a major national contractor, which did not include an original contract amount and adjusted contract amount on its subcontractor change orders. Why would a contractor not show the adjusted subcontract amount on its change orders? Maybe it's that the contractor does not want an Owner or auditor to be able to tell what the actual contract values are. This very sophisticated contractor could sort its job cost and subcontract cost in a myriad of ways. By including just certain subcontract change orders (Not including all the credits and backcharges) in some sorts the cost could appear higher than actual. If you think you might have this problem, speak up.

ADDITIONAL FEE FOR SELF-PERFORMED WORK

It has become common in parts of the country to see contractors request additional fee for self-performed work. This trend seems to have picked up steam as contractors that actually did some trade work began to differentiate themselves from those that brokered 100% of the trade work to subcontractors. Of course the basic arguments for additional fee does contain some logic; an Owner would pay a higher markup to a subcontractor and that there is some additional overhead required in the performance of trade work. Logically, then the reverse would be if work can't be self-performed and does not require additional overhead then no additional fee should be paid. You might be surprised when you ask the contractor to define what constitutes self-performed work. Recently we have heard a contractor explain that in addition to carpentry they intended to charge a self-performed fee on clean up labor, dumpsters, labor for OSHA protection and weather protection. While this example may seem absurd we have almost never seen a contractor that was given an extra fee on self-performed labor or work separate clean up as a non- self-performed item. Referring to our original assumption, since miscellaneous clean up cannot be subcontracted easily and is not a drain on overhead then no additional fee should be allowed, and your contracts should be clear on this point.

"Next time you are calculating GMP, consider if your allowances are clearly defined by the scope, are truly unknowns, and is clear as to how they will be bought out. If the allowance was estimated by your contractor, consider capping the allowance as a not to exceed. If the contractor wants to add to the allowance amount, so what! ***The risk in not capping the is on the Owner."***

SHOULD CONTRACTORS BE RESPONSIBLE FOR ALLOWANCE OVERRUNS?

The basic language in the AIA contracts and most other construction contracts states that allowances are to be reconciled to actual cost by a change order. If there is an overrun the Owner adds to the contract and an under-run decreases the contract amount. Both events are at no risk to the contractor. This especially makes sense when the Owner or Architect establishes the allowance amount or when the scope has not been defined to any reasonable degree. But, should the same hold true when the contractor is the one establishing the allowance amount or if the scope is reasonably defined but the exact cost to the contractor has not been confirmed? Additionally, should the contractor bear some responsibility in purchasing the allowance work as efficiently as possible?

Unfortunately, we have seen two projects in the last couple of years where certain contract allowances were exceeded by many millions of dollars. In some cases, the contractor was aware of the insufficiency of the contractor established allowance amounts prior to contract and yet did not inform the Owner. In another case the allowance work was all done T&M with unskilled laborers, we assume because any cost overruns would be paid by the owner.

Next time you are calculating your contract GMP, consider if your allowances are clearly defined as to the scope (labor and material, labor only, fixtures, fixtures and pipe, etc.), are truly unknowns, are clear as to how they will be bought out, and if the scope is mostly known and if the allowance was estimated by your contractor, consider capping the allowance as a not to exceed. If the contractor wants to add a little to the allowance amount to make it a not to exceed, so what. All of the risk in not capping the allowance is on the Owner and if the allowance does actually cost less than a deductive change order is in your future.

CONTRACT REVIEW

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INSIDE THIS ISSUE

CHANGE ORDER PRICING

Recently we were asked to review the cost and change orders to a contractor. During the audit we found some interesting things that might be interesting to you.
We noted that as a rule the change order requests from the subs did not seem to be altered in any way. In other words, the change requests from the subcontractor were simply passed along to the owner. The theory seems to be that if the Owner thought the amount was O.K., why should the contractor deal with it?
An audit of one of the subcontractors indicated that the labor rates in the estimates were inflated over 30%. The estimated cost of material was inflated almost 45%. The subcontractor was adding the contractual fee above the inflated cost of the change order.
We all know change orders are, as one contractor told us, "just an opportunity". However, some opportunities are more lucrative than others. In most contracts' terms, whether the contract is cost plus or lump sum, the general contractor is paid a fee based on cost or estimated cost. There is every incentive to make sure the subcontractor's change orders are as costly as possible and very little incentive to make them as cost effective as possible.

Careful review of selective change order pricing could save your company substantial dollars in construction cost each year. If your Contractor is not doing a review of the cost, maybe you should consider an overhaul, starting with the contractor's management.

GENERAL LIABILITY INSURANCE AND FEE

By all accounts from insurance brokers, the cost of General Liability Insurance is on the rise. This has several implications for Owners that we would like to discuss. First, while cost may go up on renewal of a contractor's policy, that doesn't mean the current cost is higher. Some contractors may attempt to pass on the future cost to you now. Additionally, with higher costs, some contractors may elect to self-insure or purchase high deductible policies, which serve the same purpose. The true cost of these types of policies may be very difficult to determine. In fact many large contractors have counted on the difficulty of insurance calculations to inflate their costs of GL Insurance for years. One contractor got so bold as to include hypothetical cost for insurance they didn't even have and called the costs "self-insured". Another audit revealed an internal memo from the company president that required GL charges of .8% on GMP jobs and .3% on lump sum work. It now appears that this contractor "GL Self Insurance" trick has spread nationwide.

One way of leveling the playing field in a bid situation is to require that the contractors include the cost of GL and Umbrella insurance in their fee quote. A large contractor wanting a 2% fee and 1.1% for GL insurance somehow managed to quote only 2.5% for fee and GL when the bid was restructured. One of our clients that builds worldwide has been using this approach for 14 years and another northeast client began several years ago when cost of GL insurance seemed to be excessive in its contractor bids. We believe that such an approach is prudent for most medium to large projects and in most areas of the country when larger contractors are included on the bid list.

RECRUITMENT COSTS

Occasionally we run into a contractor billing recruitment costs or headhunter fees to reimbursable cost of work. We believe the trend picked up steam a couple of years ago when contractors began having a more difficult time finding and keeping employees. We hope it is obvious to most of you that personnel costs and the human resources function of a contractor are part of home office expense, and therefore, not reimbursable except in the contractor's fee. As contractors had to spend more money on recruitment they began to test the waters on larger work to see if any unsuspecting Owners would reimburse them for headhunter fees. Some of you did. Today we are seeing contractors venturing out further into the ocean of owner acceptance and billing these fees on even mid-size projects. Regardless of the need for qualified employees to build our project, do not lose sight of what this recruitment cost is. It is a home office personnel expense that will benefit the contractor over the employee's entire tenure and is a substitute for the contractor's own home office employees chasing down leads for qualified candidates.

VARIABLE AND VERIFIABLE

If one phrase can most clearly define reimbursable costs, it is variable and verifiable. As Owners we expect to reimburse those costs that a contractor has incurred because of our project (and only our project) and are verifiable by the Owner. Costs that may be variable but are not verifiable (like persons working on our project in the home office) are not reimbursable under typical contract language. Cost that is verifiable but not variable (like fixed data processing expenses) is also not generally listed as reimbursable. Of course, costs that are not reimbursed directly by the Owner are costs that must be covered in the contractor's fee. The more of these costs that a contractor can move to reimbursable (without reducing the fee) the more of the fee can go to profit.

"FIX THE RATE, IT'S TOO HARD TO AUDIT"

We have heard the argument of fixing a rate because it is too hard to audit hundreds of times. Obviously, it depends on who is auditing how hard it is. Since we perform these tasks several times a week it is rather simple to determine

Given our experience, ***it is very simple for us to determine actual expenditures*** *like payroll taxes, employee benefits, and workers compensation insurance with a great degree of accuracy.*

with great degree of accuracy, actual expenditures for all kinds of detailed costs like payroll taxes, employee benefits, workers compensation insurance, etc. Since a contractor's existence is based on estimating and tracking costs it is nonsensical to think that there are some costs incurred and paid by the contractor that are just too difficult to calculate accurately when it comes to giving an accounting to the Owner.

PAYMENTS MADE OUTSIDE THE CONTRACT

Many Owners make payments to their contractors outside the GMP contract. Sometimes these payments are for pre- construction services or work performed prior to establishing the GMP, and sometimes for change orders that for some reason the Owner wishes to pay separately. It might be surprising to some that in a high percentage of these cases the contractor accidentally commingles these separate costs into the accounting of the GMP contract costs. On one large contract, the contractor sought to get reimbursed twice for building permits paid by the Owner separately, in the amount of $125,000. On another project the Owner had paid $60,000 for the demolition of an existing structure separately only to almost pay for the cost again when the contractor included the same cost in the new building GMP.

CONTRACT REVIEW

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INSIDE THIS ISSUE

MARKET RATE PAYROLL BURDENS

We have always advised our clients not to agree to fixed payroll burden rates. Generally, we have been successful in convincing Owners that fixed rates are a profit center for contractors but sometimes wonder if our message seems self- serving and is therefore discounted. Many new owners we work with have agreed to fixed rates and for those other construction project Owners using fixed labor and burden rates or for those leaning in that direction, we hope the following discussion is enlightening.

In addition to our finding that contractors most times overstate the legitimate elements of payroll burden to enhance profits, there is another nuance that must be considered. Look at the relationship between payroll benefits and base labor. Payroll benefits for salaried employees can make up the majority of payroll burden cost. Benefits can include vacation, holidays, health insurance, retirement, etc. All of us that are employed by a company consider the tradeoff between benefits and salary. Many contractors that wish to agree to fixed burden rates argue that their fixed benefit burden rate is competitive to other companies. This could be so, but it is possible that your contractor is paying higher than market salaries to make up for lower than market benefits. If so, by agreeing to market fixed burden rates you have in effect paid twice for these benefits and the contractor has negotiated extra profit.

Additionally, market benefits vary from region to region. We might employ a contractor from Atlanta to work on a project in Phoenix.

What is that contractors' market for benefits and how can anyone know what it is? To further complicate an Owners analysis, this last year we have seen clever contractors negotiating fixed burden rates that seemed to the Owner to be reasonable. Upon reading the fine print, we discovered that these "reasonable" rates for total labor burden (including taxes, insurance's and benefits) only applies to benefits and the contractor was separately charging for taxes and insurance.

Lastly, the consistent reason given by Owners for agreeing to fixed burden rates is that it is easier to review and there is nothing to audit. Unfortunately, this is far from reality. Most, if not all, of the fixed burden rate contracts we audit show that the contractor has charged the fixed rate (which in and of itself is usually greater than cost) and also some of the actual benefit costs to the project such as vacation, holiday, sick time, project manager vehicles, etc. Not surprisingly we find the same type of duplicate billings when we audit fixed general condition contracts. In such contracts, the contractor bills for the fixed general condition cost and charges some of the same cost to Cost of the Work.

In summary, why does your contractor want you to fix the burden rate? To make it easier on you? Hardly! One pre-audit last month showed that a New York contractor had overstated its fixed labor burden request by 17% on salaried labor. The estimated cost difference was $350,000.

DEFINING ALLOWANCES

Almost every construction contract includes allowances. By contract terms, allowances are to be reconciled to actual cost to the contractor. Unfortunately many contracts fail to adequately define what is to be included in the allowance reconciliation. A recent contract we audited included a structural steel allowance. The contractor billed labor, material, clean up, crane cost and other items into the steel allowance reconciliation. The Owner did not contemplate all the associated costs to be billed under this allowance item. The dispute exceeded $2 million. A couple of simple words such as “material only” next to your allowance items can save you many anxious moments.

DEFINING WHEN PRE-CONSTRUCTION BEGINS AND WHO IS INCLUDED

A mistake that most contracts make is in not specifying when pre-construction begins. When contracts make pre-construction costs reimbursable, the contractor often includes all of its cost including - those spent marketing and bidding to obtain the job. As auditors, two years later, it is difficult to know when the contract was awarded or when the intent was for pre-construction to begin. Likewise, the Owners personnel sometimes can’t remember or are no longer available.

WE DON’T HAVE ANY APPRENTICES

A recent pre-audit of a contractor who intended to self-perform some of the trade work had the contractor requesting to bill for union labor at fixed rates. The contractor had prepared tables of rates for journeyman, foreman, and superintendent as well as overtime rates for these classifications. The dialog went something like this: We asked, "Where are the rates for apprentices?" “We don’t have any apprentices”, was the reply. We asked, no apprentices or no rates for apprentices? “No rates” was the modified reply, “But we aren’t going to have any apprentices on your job”. “What if you have apprentices by accident”, we asked, “What rate is billed to the Owner?” “Our policy is to bill the journeyman rate regardless”, said the contractor. “The Owners policy and the contract make it clear that they do not pay for cost that you (the contractor) do not incur”, summarized the auditor.

“The contractor billed labor, material, crane and other associated costs into the structural steel reconciliation. The Owner did not contemplate these costs to be billed under this allowance item, resulting in a $2 million dispute. Remember, a few simple words next to the allowance item like ‘material only’ could can save you time and money in the future.”

LEASE CONSTRUCTION AUDITS

Some of you know that we provide our services to Companies that are tenants of leased space where the ultimate lease rate may be partially or solely based on the construction / tenant finish costs. Typically the lease stipulates the terms of reimbursable or includable costs from the developer and contractor that are used in the lease calculation. By identifying costs incorrectly billed by the contractor to the developer we have been able to reduce the corresponding lease rates. These build / leaseback arrangements have been used for many years but typically only a fraction are audited. While many projects might benefit greatly from these services, special emphasis should be given to those projects where the developer and contractor are one and the same.

While we have numerous developer clients that regularly audit their contractors as part of their development services, many other developers do not. We recommend that leases contain a provision that allows audits of contractor costs included in lease calculations. Additionally, to insure qualified and experienced audit representation, both lessee and lessor should have input in appointing or approving the audit firm.

CONTRACT REVIEW

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INSIDE THIS ISSUE

ANDERSEN IMPRESSES ONCE AGAIN

Rarely do we take the opportunity to praise a contractor that treats an Owner fairly. One such contractor is Andersen Construction, Co. located in Portland, OR. CCM has had the occasion to audit Andersen four times over the last six years and each time we have struggled harder to find any fault with their accounting of job cost. We could tell you stories that you would be sure to be fiction about how Andersen has ignored contract provisions that would have resulted in greater fees because “it wasn’t right”. Andy Andersen will have been in business 50 years in July 2000. He told us recently that many years ago when he was first starting out that someone told him a well-treated Owner was a free salesman on the road. “You don’t have to pay their salary or mileage but they are out selling for you every day.” Since we realize that it is just as valuable to know who you can trust as who you can’t, Andy again has a free salesman.

OFF THE RECORD INSURANCE SETTLEMENTS

Last newsletter we talked about subcontractor backcharges that occur off the job cost record. The same can occur with insurance settlements on claims for builder’s risk and contractor’s equipment. Over the years we have discovered hundreds of thousands of dollars in claims settlements that were not credited against job cost and instead went in miscellaneous income for the contractor. Most of these cases occurred when the Contractor provided its own builders risk insurance. In these situations, a claim can be filed (and payments made) without the Owner knowing a loss has occurred. Of course all of these cases were clerical errors and were corrected once the Owner became aware of the situation. It is very likely that many more cases have occurred than we have uncovered though. If you are aware that a loss has, or could have occurred, a good practice is to make sure the Contractor knows you know and then follow up in checking on a job cost credit.

UNIT RATES AND THEIR LIMITATIONS

Some years ago we wrote about unit rates in contracts and how sometimes the rates are used for quantities that were not contemplated when the contract and the rates were established. The example used then was a unit of contaminated soil on a cubic yard basis. The proposal to the contractor instructed that there might be 100 cubic yards at the site. 15,000 cubic yards were removed using the same unit rate established for 100 cy.

This time we want you to think about rates for heavy equipment quoted on an hourly unit cost basis. What might be fair for several hours or days of T&M work might not be fair to the Owner when the T&M dirt work lasts for three months. Assuming the hourly unit rate is in fact a daily rental equipment rate divided by eight hours in a day, then a fair monthly rate would be 40% less than the sum of four weeks of the daily charges. We assume, as is common in the industry, that three days equal a week’s rental and three weeks equal a month.

Next time you are forced to perform an extensive amount of T&M work, review your unit rates and see if they still apply or should be renegotiated.

SHOULD YOUR CONTRACTOR HAVE THE RIGHT TO APPROVE THE AUDITOR

We recently were asked to perform an audit of a large general contractor on the West Coast. The contractor had gotten the Owner to agree to allow the contractor to approve the auditors. We had audited this contractor several times in the past two years with the Owner receiving credits of $700,000 on one and $200,000 on the other. The contractor, understandably from their point of view, refused to allow our firm to perform the audit. In fact the contractor insisted that only auditors that are not specialists in construction auditing would be allowed to audit the contract. Obviously, the Owner did not contemplate this situation when the contract language was inserted. Be aware that few contractors welcome an audit and even fewer want an auditor that knows the business.

SHOULD YOU AUDIT THE GMP BEFORE YOU SIGN

Many GMP contracts start out at preliminary amounts and after documents are finalized a final GMP is agreed to as a change order. Often our clients will ask us to audit the GMP estimate to insure it is a reasonable, bonafide estimate of cost. Unfortunately, one client recently had an experience on a large project that underscored the reason why it pays to review estimated cost prior to signing the GMP. This GMP change order had numerous adds for insurance's, bonds, taxes and permits and a credit for owner-controlled insurance program. Our review after the GMP was signed showed that the GMP was overstated on these items alone by $2,500,000.

While the magnitude of the overstatement in this case was large it is not atypical of the items that we find are overstated. Other audit steps might include reviewing the basis for the subcontract values used in the estimate, focusing on the sub bids and if the lowest subcontractors' bids were used and auditing the estimated labor rates and payroll burden cost in the estimate to name a few. Since there is no guarantee at the time the GMP is agreed to that the contractor will be in a savings position at the end of the project every dollar saved in the estimated cost might equate to a dollar saved at the end. Additionally, a dollar saved at project completion may not be as valuable as savings in contract price in the beginning.

RELATED PARTIES

You have a contract with your GMP Contractor who is self-performing the millwork. When you finally get around to auditing the actual cost of millwork, your Contractor tells you that the millwork was performed lump sum by a subsidiary of the Contractor.

OR, you audit your contractor and discover insurance payments that are 50% higher than on your last project. Turns out that your current contractor "buys" insurance through an affiliate insurance company.

OR, you think that the limitation of monthly and maximum equipment rent is covered in your contract only to find out that equipment is rented to the contractor by a separate company with the same mailing address.

OR, you discover that all craft labor is "subcontracted" to a company that is controlled by the Contractors majority Owners. Of course, the billing rates for this labor are 20% higher than actual employee cost from your last job.

These are actual examples from projects we have audited in the last year. The value of the difference between actual cost and the lump sum amounts billed on these four examples was $860,000. Every quarter or so we see a Contractor that argues that they have entered in to a lump sum agreement with a related party and therefore, even if the contract gives the Owner the right to audit the Contractor, this right does not carry over to the related party.

Surprisingly most contracts do not address such an event. One suggestion is to include a definition of the Contractor that mentions parent companies, all companies owned or controlled by the parent company, all companies owned or controlled separately by the Contractors Owners and all subsidiaries of the Contractor. Additionally, in the "Cost to be Reimbursed" section of the contract, you might state that any related party cost will be reimbursed at the actual cost to that related party.

CONTRACT REVIEW

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GENERAL CONDITIONS COSTS ASSOCIATED WITH DELAY

It has been several years since we have discussed which general condition costs (G.C.'s) are associated with delays. Just as important as which costs are associated with delays is which costs are not. Those of you inclined to agree to G.C.'s on time related change orders also might realize that most G.C.'s don't change when time does not.

Basically, G.C.'s can be characterized in three groups. 1.Volume or contract sum related cost - These types of cost include bond, general liability insurance and builders risk insurance. In most cases, if the contract price does not increase these costs do not increase and yet if the contact goes up or down these costs do likewise. 2.Event related cost - These types of cost occur usually once or twice during the job regardless of duration. An example is mobilization and demobilization. 3.Duration related cost - These costs include project management payroll and trailer rentals as well as all other cost that vary with time.

Often we see contractors arguing that general condition costs should be added to change orders. Often they attempt to apply a percentage to changes that represents the effective percentage of G.C.'s to contract value. Clearly without an extension of time much of this request would be without merit. Likewise, when you are faced with a time extension that is compensable then G.C.'s to be added should only include duration related cost and any effective percentage calculation by the General Contractor would overstate the actual time related cost.

APPRENTICES AND T&M WORK

Many construction projects have a fair amount of T&M work. Sometimes the entire job is T&M and sometimes only that work that cannot be bid is subcontracted on a T&M. Additionally, a contractor may self-perform certain work and charge to job cost at T&M rates. Regardless, seldom does a contractor offer an apprentice rate on T&M work even though these same contractors are often quick to charge a higher rate for a foreman. First realize that most union jobs have 5% to 15% of the workers at some level of apprenticeship. The first level of apprentice can earn as little as 40% of a journeyman and the final level might be 90%, with typical average of 70% to 80%. Since in some localities the base union journeyman rate can be $30+ per hour and you also include the associated savings in taxes, workers comp and markup, you can see what a difference an apprentice rate can have on total labor billings.

Often, we have heard a contractor argue that apprentices are less efficient than journeymen therefore it is not proper to estimate using a weighted average cost that includes apprentices when establishing a T&M budget or estimating a job. This point may well be true, yet, when a contractor bills based on actual time spent, as is the case in T&M work, and the actual time includes apprentices, any inefficiencies are being paid by the Owner so actual cost savings for apprentices should be credited. We recently identified and recovered over $500,000 in overstatement of apprentice labor cost on one job and $180,000 on another.

NO BACKCHARGES TO SUBCONTRACTORS

Most of you know that backcharges are where a contractor charges back to a subcontractor the work performed by another subcontractor for damages caused by the first subcontractors field force. Seldom does this situation not occur

on a project, yet we often come in near the end of a project and find no credits have been processed to subcontractors for damaged work. This is not to say that on these same jobs that work has not been damaged or that subcontractors have not been given additive change orders to repair work damaged by others.

The above situation might have several explanations. One possibility is that the contractor legitimately could not identify the subcontractor that caused the damage. While this situation does occur, most damage can be readily identified with that trade that was working in the area in question. Another possibility is that the contractor has adequate room in its contract with the owner and the contractor sees no need to collect from a subcontractor since it is the owner's money that being used not the contractors. On jobs where the contractor has no budget pressure lack of backcharges is very common. Also, another possibility is that the contractor was expecting to collect on backcharges owed after it settled with the Owner on cost. We have seen many clever ways attempted by contractors in this area.

If your contract and contractor fit this "no backcharge" profile some inquiry might be in order.

OVERSTATEMENT OF RETIREMENT COST

Most successful contractors and subcontractors have some form of retirement plan. These plans can include 401K plans in which the company matches a percentage of the employees' contribution, up to a cap, or profit sharing plans that the company's contribution can vary based on the overall profitability of the company. Most companies require some kind of waiting period before employees can enroll in these plans. Some enrollment periods can be as long as 1.5 years. Obviously, longer enrollment periods make it more likely that not every employee of the contractor is enrolled, and lack of enrollment means no company expense. A waiting period of one year may mean that the effective cost of retirement to the contractor is reduced by 50%. It may shock you to learn that many contractors ignore this fact when charging owners for the payroll fringe benefit cost of retirement plans.

PRE-CONSTRUCTION AUDITS

Many of our clients are having pre-construction audits or audits of cost very early in the project. We have found that this use of our time is very beneficial to our clients.

Labor is a big part of the cost of any project, and labor is one of the costs that varies the most from contractor to contractor. We see union trade contractors with wide variances in the labor rates billed to the owner even between trade contractors in the same city.

The interpretation of what is included in labor burden, how to calculate overtime, and other stuff included in labor burden can cause the billing rate to vary widely between two trade contractors in the same market in the same union. We recently audited a contractor that included safety, parking, auto and truck rental, welding certification, drug testing, and equipment insurance, etc. in the labor burden. All of these costs were reimbursable on this particular project, but not as part of labor burden.

Just one example, the vehicle insurance was being charged as if every employee on the project had a vehicle owned by the contractor. The truth is, only the superintendent had a company owned truck. Parking was treated the same. The contractor assumed every employee had to pay for parking. As it turned out, many of the contractor's employees rode together to work.

The advantage of the pre-construction audit of the project was that the contractor had not had an opportunity to bill using the inflated labor burden. We reduced the rate by more than 50% and the contractor agreed to bill most of these expenses accompanied by receipts for the expenses. (A savings of over $1,000,000.)

In another pre-construction audit, we discovered a general contractor with all-inclusive rates planning to bill the holidays, sick days, and vacations to cost of the work when in fact these benefits were included in the billing rate. By billing for these paid time off days, the contractor was billing the benefits twice. This saved our client over $100,000 for one contractor alone.

On lump sum projects, establishing proper labor rates for change orders can also save thousands of dollars depending on the value of change orders.

The benefits to the owner are greater than just the direct expenses saved. Pre-construction audits require small amounts of hours for the potential return. Usually, a pre-construction audit takes no more than a day or two per contractor. Second, there is no negotiation of the amount of the money owed back to you. Since these amounts are never billed and paid by you, you receive 100% of the savings.

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DOES PAYING FOR HOME OFFICE EMPLOYEES MEAN THEIR DESK ALSO?

On cost reimbursable contracts, sometimes Owners will allow the Contractor to bill some or all of the actual cost of certain office-based, non-jobsite employees. Over the past 10 years we have seen a trend in Contractors taking liberty to bill for overhead costs associated with these employees also. These costs can include; desktop computers, cell phones, printers and home office parking. Some Contractors even include an overhead absorption percentage on the actual wage to cover rent, utilities etc. when an Owner believes they are paying for labor cost only.

We have heard Contractors argue that if these home office personnel were at the job site the Owner would pay; the trailer rent, computers, phones and utilities. Therefore it is only fair to charge the jobs for a portion of these same costs at the main office. The fairness of the issue mainly can be analyzed based on Control, Variability of the expense, and what does the fee cover anyway?

• Control – At the jobsite the Owner can see the person and the equipment that they are using. The Owner can decide not to purchase the latest P.C with the super graphics card and surround sound for the job site.

• Variability of the Expense – If the job did not exist there would be no need for a job site trailer. The home office rent and utilities would go on as usual. Home office management employees and their perks not to mention rent and utilities, are not variable to our project and Variability of the Expense – If the job did not exist there would be no need for a job site trailer. The home office rent and utilities would go on as usual. Home office management employees and their perks not to mention rent and utilities, are not variable to our project and therefore not reimbursable.

• Fee – The Contractor's fee is stated as a percentage or a fixed amount. This fee is either bid or negotiated based on the market. The fee is used to cover overhead expense first and if any is left over, profit. How much goes to each is not the Owner's concern until the Contractor tries to argue that fee does not cover some types of overhead expenses. Remember that the fee agreed-on covers all overhead expense.

Consider making this issue clear next time you are tempted to agree to reimburse for home office personnel.

DOES YOUR CONTRACTOR DO A GOOD JOB IN SUBCONTRACTING?

Many Owners believe that it is the Contractor's responsibility to define the terms and conditions of its subcontracts. Clearly the Contractor has the contractual relationship but what is done or not done in the subcontract can cost an Owner dearly. Recently we have seen a Contractor negotiate a GMP contract with a subcontractor without any definitions of reimbursable cost or fee. The Owner believed that they were getting protection against overstatement of the contract price with a savings provision, only to find a subcontract where the accounting of cost-plus fee was impossible.

Not too long ago we ran across a similar situation where the Owner directed the Contractor to negotiate subcontracts with two large subs on a GMP basis only to discover after the job was over that the Contractor converted the GMP quotes to lumpsum.

Just as bad was the Contractor who subcontracted for a design build system with four subcontractors yet never defined the criteria for electrical or plumbing fixtures to be used. Don't think that when a subcontractor and the general contractor get into a dispute that it doesn't cost the Owner money.

Our recommendations are; (1) If you agree to a GMP subcontract, make sure that the terms are understandable and consistent with the Owner/GC contract. (2) Even if you have lumpsum subs, verify that allowance reconciliation language is consistent and there are limitations of sub mark-up on change orders that are acceptable.

PENALTY FOR AUDIT FINDINGS

It comes to no surprise to most of you that we at CCM have a thriving business. After all, we pay for ourselves on almost every audit assignment. Why? We could say it's because we are skilled at what we do and it would be partially true, but if Contractors did not attempt to overstate cost there would be no need to audit for contract compliance. Why do some Contractors attempt to overstate cost and not comply to the terms of the contract?

Part of the pressure to overstate the Owners cost may come from very competitive market fees. Contractors sometime feel forced to sell work at fees that will not sustain the company and they resort to overstating cost to close the gap. Also there is a very fundamental micro economic reason for widespread non-compliance. There is usually no penalty for doing so.

We all know the potential penalty for filing a false income tax return. If the only penalty for errors on your income tax return was paying the amount you would have owed anyway and at no interest, how many correct returns would be filed?

Most construction contracts require a contractor to pay at its own expense, work discovered to be faulty and not in conformance to the contract documents, including the cost to uncover the work. In the case of cost overstatement by the Contractor, the cost of uncovering the work to determine an overstatement is the audit expense. If the audit discovers faulty billings shouldn't the Contractor be required to pay for the Owner's cost just as clearly as if the Owner had hired a backhoe operator to find utility lines misplaced?

Consider on all your contracts to insert some audit reimbursement language if an audit discovers overstatements of cost to the Owner.

RELOCATION EXPENSE LIMITATION

We recently performed an interim audit on a $30,000,000 project where the Contractor had charged over $150,000 to job cost for relocation. The project was located in the Contractor's hometown, and the GMP estimate had no money for relocation. Should the Owner be obligated to pay for relocation of employees without its prior approval? Is there a limit on reasonable relocation? Is it possible that a Contractor will chose to relocate employees on a GMP job back to its home office location and use its local employees on its lumpsum work?

This issue comes up in an audit at least once a year. A local Contractor is hired to work on a local project. The GMP estimate has no amount for relocation, yet $20K - $40K and even $150K is charged to the Owner. If your expectation is that there will be no cost for relocation, state that expectation in your contract.

CONSTRUCTION COST PRIOR TO CONTRACT AWARD

On GMP contracts, Contractors want to be reimbursed for all their project expense. Sometimes these project expenses include bid cost, sales and marketing trips to the client and more. Generally, cost expended prior to contract award or intent to award are non-reimbursable. It will come to no surprise that we have seen cost charged to job cost as much as a year prior to contract award. On one project we even found a Contractor reclassifying the relocation expense of an employee from two years earlier.

"If your expectation is that there will be no cost for relocation, state that expectation in your contract."

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SELF-INSURANCE COSTS

Several years ago, we wrote about what self-insurance should cost. Since we have recently run into this problem several times, we feel it might be important to discuss the subject again.

Theoretically, a contractor would only elect to be self-insured if it thought that the actual cost of claims and administration would be lower than a hard cost contract with an insurance company. Part of this decision is an estimation of when claims will be paid out and what these deferred costs are worth today. Interestingly, these same basic understandings are often ignored when a company charges a project for its self-insurance plan. We have heard many different defenses for the charged rates exceeding what one would expect to pay to an insurance company; including the extraordinary risk that the contractor is assuming and that Owners would not be willing to pay for claims in the future therefore failing to discount future payouts would be proper.

Typically we would argue that the decision to self-insure is not unlike the Construction Company making a side bet with its insurance company on the real cost of claims. This side bet should not effect the cost of insurance to the project and in no case should the Owner be required to pay costs in excess of market.

RELATED PARTY SUBCONTRACTORS

You enter into a GMAX contract with a general contractor who routinely self performs millwork. You find out when the project ends that the G.C. considers the millwork shop to be a separate entity and the millwork was performed lump sum to the G.C. Seem Fair? This situation has You enter into a GMAX contract with a general contractor who routinely self performs millwork. You find out when the project ends that the G.C. considers the millwork shop to be a separate entity and the millwork was performed lump sum to the G.C. Seem Fair? This situation has happened to our clients twice in the last four months.

Obviously, an owner can run a risk of paying too such when a captive company is allowed to do work for a G.C. and even greater risk if such work is lump sum. Lack of arm's length buying procedures or the appearance of preferential treatment may well result in an inflated price, even if the work is bid. Scrutiny of the subs change order prices may also be compromised. Before you casually allow the G.C. to self-perform work consider the following:

• Is the captive a legitimate subcontractor or just a way for the G.C. to make more fee?
• Does the sub regularly perform work for other general contractors or Owners? If not, consider not paying additional OH&P on the self-performed work.

Since any bidding of the subs work can be suspect, consider making any self-performed work a "Mini- GMAX".
Don't fool yourself into thinking the G.C will negotiate in your favor with the in-house subcontractor. Plan on participating in any bid scope or pricing meetings. On a recent audit, the in-house sub was awarded a lump sum subcontract after bids were taken. The in-house sub was the highest out of five bidders. The G.C. indicated that the other bids were either

incomplete or the other subs could not accomplish the schedule. Independently, we verified that neither of the two lowest subs was contacted by the G.C. after they faxed in their bids.

BEWARE OF CREW RATES

We often encounter labor costs on change orders calculated at what can be described as an average crew rate. The following is an example of a typical crew rate calculation:

5 Journeymen at $30/hour	$150.00
1 Foreman at $35/hour	$35.00
1 General Foreman at $40/hour	$40.00
EQUALS =	$225.00
Divided by Productive Hours	5
RATE PER HOUR =	**$45.00**

Theoretically, this calculation is trying to determine the actual cost of one productive labor hour. However, the above calculation has flaws in its logic when used for pricing change orders. First, most foremen are at least 50% productive. This means that the crew cost should be divided by 5.5 productive hours rather than 5. Second, the general foreman is essentially a fixed cost. Assuming that a change order does not extend the contract schedule there should be no additional cost for a general foreman. Making the above changes adjusts the change order crew rate as follows:

5 Journeymen at $30/hour	$150.00
1 Foreman at $35/hour	$35.00
EQUALS =	$185.00
Divided by Productive Hours	5.5
RATE PER HOUR =	**$36.64**

NEGOTIATING FROM STRENGTH

Recently, in a discussion with a prospective client, the topic of change orders came up. The project manager proudly exclaimed that he had negotiated $2,500,000 of change orders on a project and had saved his company an average of 10%. When we asked how he had accomplished this, he said that he just marked each change request down by 10%, or so, and forced the contractors to accept this new number.

While the project manager undoubtedly saved his company some money, in all likelihood he did not cut all the “fat” out of the change orders.

Our experience has shown that many contractors include a “fudge factor", or contingency, in every change request. This is especially true if the Owner has a history of arbitrarily cutting change requests. There is a good chance that the contractors had figured out the project manager’s game, and had included sufficient contingency in their change requests to cover both the Owner’s cut and make some extra profit.

This owner was negotiating from weakness. We suggest negotiating from strength. Many of our clients require their contractors to provide full cost estimates with all change requests. Profit, if allowed by contract, is added as a separate item. The client is then able to negotiate, or re-estimate, the contractors’ material quantities and production rates; these are the areas where project managers and architects are typically the most capable and the most comfortable. They then accept the change order "subject to audit". The financial representations such as labor rates and payroll burden made in the change request can later be audited and adjusted if necessary.

This method helps produce change orders which only include the costs and profit allowed by your contract.

CONTRACTOR ACCOUNTING

Over the years, we have occasionally encountered a contractor with a deficient accounting system. Be sure that your GMAX contractor has an adequate accounting system that can report his final costs of the contract as well as documenting his change order pricing. If you have allowances or T&M change orders, make sure he can accurately track the actual cost of those, as well. Ask a few questions during your contractor selection process about how the contractor tracks his cost.

If you still have doubts, feel free to call us.

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LIQUIDATED DAMAGES USES AND LIMITATIONS

Damages are awarded to one party in a contract upon breach of the other. Some contracts where time of performance is critical seek to stipulate the amount of damages due to either party due to non-performance. Clauses that stipulate damages to be paid are called liquidated damage clauses. Liquidated damage clauses containing damages substantially higher than actual losses are interpreted as penalty clauses and not enforceable.

Courts generally list three criteria by which a valid liquidated damages clause, can be distinguished from a penalty clause: (1) the damages caused by the breach must be difficult or impossible to estimate; (2) the parties must intend to provide for damages rather than for a Penalty; and, (3) the damages stipulated must be a reasonable pre-estimate of the actual damages.

Construction contracts commonly have liquidated damage provisions. Damages due to delay in a contract to construct a commercial building are sometimes not easy to estimate, satisfying criteria number one above, however a reasonable pre-estimate of actual damages can also be a difficult task.

Consider the following case as it relates to liquidated damages.

• Hospital X entered into a construction contract with contractor Y to construct a 220 bed, $75 million hospital in Florida. The project was to begin April 1, 1989 and finish October 1, 1990 just in time for the winter "season". A competing hospital had planned a remodel and expansion of its own, however, this competitor was not going to be complete with its construction until September 1, 1991.

• At the time of the contracting liquidated damages were agreed to at $2,000 per day for every day after October 1, 1990 that the hospital was not approved for occupancy.

• Within a few months after construction had begun, schedule delays began. The contractor also began having serious disputes with subcontractors about schedule performance. By October 1, 1990, the contractor was anticipating completion of July 30, 1991.

• The hospital hired an independent scheduling consultant to analyze the work progress and access if the new completion date of July 30, 1991 was achievable. In January of 1991 this review was complete and the facts indicated that the actual completion date could be sometime after January, 1991. Based on this analysis a recommendation was made to terminate the contractor for default.

At issue are several key questions that speak to the validity of liquidated damages. The questions are: (1) was the liquidated sum agreed upon, the parties' best estimate of what damages would be 18 months in the future? (2) is it difficult or impossible to determine the actual damage to the hospital for delay? (3) is there a point where excessive delay could be considered abandonment of the project and that liquidated damages would no longer apply? (4) is there some excessive amount of delay that was not within the contemplation of the parties and therefore after such time liquidated damages would not apply? (5) if actual damages due to the delay can be shown to be substantially greater than the stipulated sum should recovery be limited to liquidated damages?

"…liquidated damages have their uses, and in extreme conditions, their limitations. Due care in analysis must be taken by both contracting parties before liquidated amounts are stipulated."

Was the liquidated sum of $2,000 per day the parties best estimate of what damages would be, 18 months in the future? Interest cost on an investment of S75 million is predictable. At a rate of 8% simple interest the actual cost for a day of delay would be $16,438. Lost profits would also be an actual cost for delay. Loss of credibility with the users of the hospital could also be anticipated as damages.

One could reasonably estimate that the actual cost of delay would he substantially in excess of $2,000 per day. However, too little liquidated damages may be interpreted as an allocation of risk. Therefore, the risk of performance normally assumed by a contractor has been reduced by the lower than actual liquidated damages.

Is there a point where excessive delay could be considered abandonment of the project and that liquidated damages would no longer apply? If prolonged delay occurs, the court may characterize it as equivalent to an abandonment of the contract.

The hospital was originally scheduled for completion in 18 months. Based on information given by the scheduling consultant a delay of 16 months was possible. Certainly this delay could be categorized as prolonged, in fact, it might be shown that contractor Y elected to delay the project and pay $2,000 a day rather than enforce project performance by its subcontractors at a greater cost. The courts might find that the liquidated damage clause was practically an option clause. And that the contractor was merely exercising its option to delay the project and pay $2,000 per day. Delays in construction projects are common. The larger, more complex, and more regulated the project, the greater the possibility of delay. In relative terms, a 220-bed hospital is large, complex, and regulated. Even said, a 16-mouth delay is excessive and very probably outside the contemplation of the parties, It was known that a competing hospital would be built but would not be ready until the following winter season. Hospital X would have already had one full year of operation and its market share would be firmly established going into its second winter season. It could be shown that the parties had intended the liquidated damaged clause to be enforceable, but only for a period an anticipatable delay.

As can be seen, liquidated damages have their uses, and in extreme conditions, their limitations. Due care in analysis must be taken by both contracting parties before liquidated amounts are stipulated. It is possibly prudent to state in the liquidated damage clause what events are reasonably contemplated, and which risks are being allocated among the parties as to further clarify the scope and intent of a liquidated damages clause.

LUMP SUM GENERAL CONDITIONS

We have many clients that prefer to bid/negotiate construction contracts with lump sum general condition costs and make direct construction costs a GMAX. As you are aware, any contracting strategy can have limitations.

Some of the limitations of lump sum general condition contracts are as follows:

• Lump sum general conditions may cause the contractor to save money in the short term by reducing staff at the expense of proper management. Lack of management may increase the direct cost and if savings or contingency is built in to the GMAX the Owner pays all of the increase in direct cost and gets no savings in the lump sum general conditions. Additionally, the Contractor may be reluctant to spend more, although necessary, general condition money to get more supervision or engineering support if it looks as if the general conditions budget is in jeopardy.

• The contractor may attempt to shift general condition costs to the direct construction costs by requiring the subcontractors to pick up some of the general condition costs in their contracts. We have recently witnessed superintendents charged as labor foremen, dumpster and toilet rentals required of subcontractors, dust control billed as site work, subcontractor back charges credited to the lump sum general conditions, and project manager bonuses charged as cost of work.

A detailed minimum scope of work that is expected in the general condition cost is essential. Contractor employee names, positions and length of time contemplated also provide the Owner a useful management tool.

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DEDUCTIVE FEE ON CREDIT CHANGE ORDERS

A surprising number of contracts that we review or audit are silent on deductive fee on credit change orders. Even when the contract is exceedingly clear that both additive and deductive change orders should have a fee add or fee credit contractors regularly ignore the credit provision. Indeed this failure to give back fee on credit change orders in one of our most common audit findings.

Assuming that your contract is not one of the explicit ones, let's examine the equity of a fee give-back. Contracts and contractors typically quote a fee, which has both overhead and profit elements as a percentage of construction cost. In reality the return the contractor needs to cover overhead and make a profit is not dependent on construction value but rather the contractor's deployment of assets. For most contractors these assets are its ability to manage the construction process or in other words people. If change orders, either additive or deductive, do not increase the construction schedule and do not require more management personnel then any fee change would generally not be warranted. However, the construction industry has seen fit to adopt a standard fee valuation based on construction cost. Certainly there is an advantage to this approach in that any argument about how much overhead and profit individual changes should require is decided in advance by a contract agreement on the fee percentage on change order cost.

Most projects experience change orders. More often than not credit change orders occur at the beginning of the contract when value-engineering options are still being evaluated. Additive change orders soon follow and yet most project's change orders never add to the project schedule or increase the contractor's field management. On a project with a 5% C.O. fee and $300,000 in additive change orders and $150,000 in deductive ones the contractor's fee is actually increased by 10% on the net contract value increase if deductive change orders do not have a fee credit.

Obviously, equity would say that if there happened to be net reduction in contract costs due to all change orders on a project then the contractor's fee should be protected. We have seen many owners attempt to protect themselves, in the event that a substantial portion of the project is cancelled, with a provision for contractor fee reduction if the overall contract change order credits exceed 20% or more of the initial contract sum. If you are unsure of how your contract fee should be worded please contact us.

CONSULTANT REIMBURSABLE COSTS

A while back we wrote about CADD costs and microcomputer charges by some architects and engineers. We briefly mentioned certain other in-house charges for blueprints, copies, faxes and telephone. We thought it would be a good idea to focus on one common reimbursable expense – in-house copies, and possibly explain how an owner can be overcharged. The following situation occurred recently.

On a large architectural contract for an office building the architect charged 25 cents per in-house copy. The total copy cost over three years was $55,000. The architect billed for its labor at actual labor cost plus a negotiated multiplier that covered all overhead and profit. Reimbursable costs were to be billed at actual cost with no mark-up.

One block away from the architect's office was a copy center offering copies at 5 cents per copy. The architect did not keep records of their actual cost of making a photocopy. Included in the architect's overhead cost was copier depreciation, office rent, electrical bills, and office supplies, including copier paper. Given the facts stated above one could argue for reimbursable copy cost of between 5 cents and 0 cents per page. As a compromise position we calculated a reimbursable cost of 3 cents per page and asked for a $48,400 credit. This audit point would be no less valid if the architect had charged 10 cents rather than 25 cents. Ten cents would still have generated a $15,400 overcharge for the architect.

HIDDEN TEMPORARY EMPLOYEES

Many Owners' contracts with design firms call for all markups to be on the direct productive labor of the design firm's employees. Subcontracting work to other firms or hiring temporary workers through temporary agencies is not subject to the same markups as the design firms full- time employees. It is logical that the design firm would have more cost involved with its own employees than with temporary employees. We discovered an interesting way to avoid the limitation on temporary employees.

One of the firms we audited was billing temporary employees with an employee number and hours as if they were direct employees. This practice produced tens of thousands of dollars of extra profit for the firm outside the agreement with the owner. There was no way the owner's representatives could have caught this practice since the owner did not know who was full time and who was a temporary employee of the design firm. Without a complete audit of both the labor and the reimbursable costs for this engineering firm, the overcharge would have been undetected.

MAINTENANCE CONTRACTS

Many of you have maintenance contracts with companies and renegotiate the labor rates periodically. Recently, we were involved with a company who asked us to audit their maintenance contractors before they began to renegotiate these contracts. The results were interesting.

One of the contractors had a category in their rates called "Apprentices". Most specialty contractors use recognized apprentices to do part of the work on maintenance contracts. In this particular instance, there are 6 different pay rates for apprentices ranging from $7.00 per hour to $22.00. The "Apprentices" rate was $22.00 in the contract and all apprentice hours were billed at $22.00 per hour. Total hours performed by apprentices was about 1/3 of the total hours worked. During the audit we determined that only about 25% of the apprentice hours were worked by the highest paid apprentices. The overcharge for apprentice hours was about $13,000 plus benefits on a very small contract.

On another contract we found that a contractor was using obviously inflated percentages for the labor burden on the labor rates. As an example, they were using 9% for FICA. FICA is of the first 7.65% of an individual's annual payroll cost all over America. Several other categories were overstated and the overcharge for this $1,000,000 maintenance contract was $77,000. In checking further, we found that all the owner's contracts, both maintenance and construction, with this specialty contractor included inflated rates totaling hundreds of thousands of dollars.

Had the owner audited all maintenance contractors prior to entering into the original contract, many thousands of dollars could have been saved. The cost of pre-contract audits is marginal compared to the potential overcharge by maintenance contractors.

As always, we will be glad to review any contract you may be considering. While not a substitute for review by your legal counsel, we are in a good position to spot potential problems due to our extensive exposure to the result of different contract clauses. Please call for further information.