Objectives

› Understand risks of most common contract types

› Understand why the contract is so important and key components to incorporate

› Understand the value in auditing construction costs throughout the project
Construction Contract

› It stipulates the terms of the contract
› It clarifies the expectations of the involved parties
› It dictates what can be audited & requested from your contractors
Lump-Sum Contract

› Benefits
  • Known financial commitment
  • Less administrative burden for owner
  • Less risk of scope creep & budget overage

› Disadvantages
  • Potentially higher markup by general contractor (GC) for unforeseen contingencies
  • Limited visibility into project costs, which can make it easier to conceal noncompliance with project specifications
    › Elimination of scope or low-quality materials to stay within budget
Lump-Sum Contract Risks

› Contractor assumes risk for bringing the project in at or under the lump-sum amount. If the lump-sum amount is exceeded, the contractor absorbs the overage.

› Contractor is paid monthly based on percentage of completion
  • Contractors often do not attach the individual invoices &/or cost support to the pay application (pay app).

› But there can be change orders, which should be scrutinized
  • Contractor may add OH&P, added general conditions, performance & payment bond costs & insurance.
  • Contract needs to define what of the above costs will & will not be allowed.

› There can also be cost overruns that contractor may attempt to attribute to the owner
  • Costs not normally included in the cost of work may cause or contribute to the overrun.
Guaranteed Maximum Price (GMP) Contract

› Benefits
  • Not to exceed price
  • May benefit from value engineering & well-managed procurement due to a shared savings clause
  • Can contract with contractor while building still under design (fast track)

› Disadvantage
  • More complex contract that needs more specifics
  • More project management & administration by owner
  • Project complexity can create opportunities for abuse
GMP Contract Risks

› If costs are coming in over budget, GC may try to pass costs onto the owner via change orders
  • Shared savings clause can help mitigate this, depending on the % shared with GC
  • If there is no shared savings clause, GC may believe max price IS their budget

› Pay apps & supporting documentation needs to be audited to ensure costs are allowable & there is no cost shifting
Time & Materials (T&M) & Cost-Plus Contracts

› Benefits
  • Can provide the owner transparency into costs
  • Easy to pivot if project specifications change

› Disadvantages
  • More project management & administration by owner
  • No incentive for GC to be efficient
  • No incentive for GC to reduce costs
T&M & Cost-Plus Contracts Risks

› Business terms & conditions are very, very important

› Risk is shifted from contractor to owner, so there is little incentive for the contractor to keep the costs down

› Definition of what is reimbursable & what is not reimbursable is important

› Monthly pay apps should include detailed support & include subcontractor invoices as well
Common Contract Issues

› Definition of cost of work is poorly defined
› The contract is silent or vague about certain costs
› Ambiguity with regard to cost results in the owner unknowingly paying for nonreimbursable costs that are not ordinarily billed to an owner in the construction industry
› Pay apps include contractor’s indirect costs which are already covered in general conditions (costs not involved in the actual construction, e.g., site & project management, material handling)
What to Evaluate Before Finalizing the Contract

› Owner’s right to audit (including what type of documentation is expected)

› Roles & responsibilities of the relevant parties are clearly defined
  • How the owner will interact with the subcontractors, if applicable
  • How the subcontractors contracts will be created, e.g., specific contract types, right to audit, responsibilities, etc.

› Allowable & nonallowable costs are clearly identified
  • Subguard, employee stock ownership plans, bonuses, contractor Enterprise Resource Planning (ERP) costs
  • Contractor-owned equipment cost limitations, small tools/misc. consumables
What to Evaluate Before Finalizing the Contract

› Financial terms
  • Overall contract cost & inclusions
  • Allowances, if applicable

› Potentially ambiguous or contradictory terms or clauses

› Cost of work (actual vs. lump sum & how that’s defined)

› General conditions (what is included & what is not included)

› Shared-savings calculation, if applicable (this will include insurance rebates & dividends)

› Scrap or waste materials (during demolition are things able to be recycled for a value?)
Why Audit?

Risk management tool
- Use contract provisions to allocate risk
- Project control processes

Ensure funding is used properly
- Minimize construction costs
- Guard against potential billing schemes or change order abuse

Aid in resolving potential disputes between institution & contractor
- Potential construction cost recovery
Change Orders

› Approved change orders that provide no value to the project
  • Potential causes: Existing scope unclear, Unnecessary scope change or expansion, Duplicative or redundant change orders

› Overpriced change orders are change orders that have been approved but are overpriced for the scope of work proposed.
  • Potential causes: Inflated labor rates, Inflated hours, Excessive profit margins, Charging “fees on fees”
Change Orders

› Contract should include detailed requirements for estimating/pricing & billing of costs

› Strong review/monitoring processes required
  • Adequate support often not provided
  • Contractor may account for change orders that increase the price, but not those that decrease the price
Change Orders

› Look out for:
  • Proper Justification of the change
  • Change order value greater than 10% of original budget
  • Lump-sum change orders
  • Higher costs (premium charges)
  • Scope overlap
  • Excessive profit
  • Use of contingency money
  • Self-performed work at increased prices
  • Pattern of low bid award followed by change orders that increase the price or scope of the contract or extend the contract period
Pay Applications

› Common findings
  • Fee computation errors
  • Overbilling
  • Unauthorized budget allocation
  • Rollforward errors
  • Missing documentation
  • Overcharging the general conditions budget
Cost Shifting

Nonauthorized transfer of costs from nonreimbursable cost centers to reimbursable cost centers

Why does cost shifting occur

- Poorly defined contract terms
- Contract misinterpretation
- Misunderstanding/poor communication between GC & owner
- Weak &/or poorly implemented controls
- Carelessness & errors
General Conditions

› General conditions are the contractor’s compensation for overhead, indirect project costs & direct costs not already accounted for in the SOV

› Well-defined cost & service coverage in the contract is key to minimizing disputed general condition costs
General Conditions

- Typical allowable general condition items
  - Project manager, assistant & superintendent labor cost (project management personnel)
  - Vehicle costs for project management personnel
  - Job trailer, utilities & job trailer furniture (not to exceed purchase cost)
  - Per diems & project management travel costs
General Conditions

› Typical nonallowable general condition items
  • Project management software
  • Profit sharing
  • Home office expenses
  • Company owner/principal labor & burden expense
  • Depreciation

› Executive transportation
  • Overtime costs for exempt employees
  • Bonuses
  • Rework resulting from incomplete or unacceptable work product
  • Anything with its own line item in the budget
General Conditions

General conditions – risks

• Costs shifted to reimbursable cost categories
• Costs shifted to subcontractors
• Costs shifted to owner direct purchases

Contract should include detailed requirements on what is considered allowable & nonallowable to avoid things like

• Too many supervisors on site
• Excessive T&E
• Sales tax on tax-exempt projects
• Rebates or cash discounts not passed to owner
• Excessive relocation, moving, transportation & communication costs
General Conditions

› Contract provisions & guidelines
  • Request rate schedules for all equipment rentals
  • Request rate schedules for all vehicle rentals
  • Verify what is included in the vehicle rental rate
    › Insurance
    › Depreciation
    › Maintenance
    › Repairs
  • Fuel costs are usually excluded from rental rates & stated as a flat daily rate or mileage rate
Contractor Overhead

- The overhead & profit (OH&P) fee charged to the owner by the contractor is supposed to cover the contractor’s indirect costs, so indirect costs should not be billed separately
  - Back-office salary costs, education, training, business license, computer software, etc.
Material Costs

› Contract & plans should include detailed requirements as to what material is requested & to be used during construction

› Be looking for
  • Materials charged from another job
  • The correct materials were ordered and delivered
  • Excessive materials ordered
  • Excessive material storage charges
  • Credits not received for returned materials
Equipment Costs

› Contract & plans should include detailed requirements as to what equipment is expected to be used on job
  • Contract should indicate what equipment is anticipated to be rented through GC
  • Contract needs to specify what is allowed
  • Use industry benchmark data
  • Charges in excess of total value

› Contractors do not necessarily own all equipment they need on a project, so they rent some equipment
Equipment Maintenance Costs

› Contractors may attempt to charge the owner for the cost of repair & maintenance of their owned equipment through the monthly general conditions section of the pay app

› This amount is normally considered part of the OH&P & not passed on separately to the owner
Labor & Labor Burden

› Labor burden percentage used is incorrect

› Labor burden includes nonreimbursable items
  • Bonuses, education, etc.
  • Contract should define what is allowable in labor burden buildup

› Unemployment tax still charged after maximum reached
Other Things to Watch For

› Subcontractor payments
› Contingency usage
› Markup on markup
Questions?