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## The Danger Buried Within: Identifying Construction Contract Red Flags

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## Presenters



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## Objectives

- › Identify risks of various contract types so that you can be aware of potential red flags & know when to step in
- › Understand why the contract is so important & the value in performing construction audits
- › Recognize areas where issues & cost recoveries are commonly found

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# The Best Defense Is a Good Offense

Two keys to cost control in any given construction project: solid contractual terms & construction audit

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## Construction Contract

- › It stipulates the terms of the contract
- › It clarifies the expectations of the involved parties
- › It indicates the support that you can be expected to receive
- › It dictates what can be audited & requested from your contractors

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## 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

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## 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

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## 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

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## GMP Contract Risks

- › If costs are coming in over budget, GC may try to make up costs via change orders
  - Shared savings clause can 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

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## 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

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## 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

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## 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)

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## 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

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## 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?)

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## 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

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## *“But, We Have Construction Management Firms Oversee Our Projects”*

- › Outsourcing the project oversight function may not remediate risk
  - Construction manager (CM) may not have owner’s best interest in mind
  - Priorities such as schedule could take precedence over cost
  - Scope & contract changes between CM & GC could occur without proper oversight

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## *“But, We Work with the Same GC & Have Never Had Any Issues or Cost Overruns”*

- › Projects completed on or under budget may still include inappropriate costs
  - Was the budget potentially too high from the outset?
  - Were scopes of work eliminated to maintain the budget?
  - Were materials of lesser value &/or quality used in order to limit costs?

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## *“But, the GC We Use Has Never Been Convicted of Fraud”*

- › Overcharges or unallowable costs are often not the result of fraudulent activity
  - “This is how we have always done it ...”
  - Lack of communication between owner & GC/architect
  - Excessive change orders/scope changes
  - Math errors

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## **Real-World Example**

- › University building multiple buildings simultaneously
- › Construction audit examined labor, equipment & insurance rates, related-party transactions, gifts in kind (GIK) & subcontractor costs
- › Identified insurance, vendor & change order overbillings
- › Reconciled labor costs to the agreed-upon costs per contract
- › Saved university approximately \$1.2 million

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## Full-Scope Construction Audit

- › Preconstruction
  - Review pricing structure
  - Review contract terms & conditions
  - Add strong audit clause
- › During construction
  - Review monthly pay applications for contract compliance
  - Review change orders (including scope)
- › Post-construction
  - Review lien waivers
  - Review punch list
  - Review allowances
  - Independently calculate any shared savings

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## Other Common Scopes

- › Contract review
- › Process/control review
- › Change order review
- › Pay app review

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# The Dangers Buried Within

What can happen in the event of unclear, vague or absent contract language or contract noncompliance

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## 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
  - Fraud

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## Cost Shifting

### › Common culprits

- Overhead costs that are not contractually allowed
- Budget reallocation
- Concurrent projects being performed for same owner
- Posting errors from unrelated projects
- Allocation of pooled costs
- Bulk or master services materials purchases
- Recovery of administrative overhead through labor & equipment rate burdens
- Overtime charges from unrelated projects
- Comingled construction management & self-performed work
- Comingled contingency & allowance budgets

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## 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

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## Change Orders

- › Approved change orders that are overpriced for the listed scope of work
  - Potential causes
    - › Inflated labor rates
    - › Inflated hours
    - › Excessive profit margins
    - › Charging “fees on fees”

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## 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

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## Change Orders

### › Look for

- 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

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## Change Order Abuse

### › Keep a close eye on the following

- Appropriate justification for the change order
- Numerous, unusual or unexplained change orders for a specific sub approved by the same employee
- Pattern of low bid award followed by change orders that increase the price or scope of the contract or extend the contract period
- Vague contract specifications followed by change orders
- Incomplete or “preliminary” specs subject to change based on later engineering studies, etc.

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## Pay Applications

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

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## Inflated Pay Apps

- › Pay apps need to be monitored & scrutinized closely for
  - Erroneous totals or line items
  - Rollforward errors
  - Missing or disorganized billing backup
  - Inflated rates on invoices in excess of actual costs incurred or false invoices
  - Missing subcontractor lien waivers

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## 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

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## 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

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## 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

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## 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

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## 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

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## General Conditions

- › Risk analysis red flags
  - Excessive vehicle rental rates
    - › Compare with blue book rates to evaluate market pricing
  - Mileage reimbursements in excess of IRS guidelines
    - › IRS guidelines cover cost of ownership. Reimbursement should be less than IRS guidelines
  - Cost of rentals exceeds FMV of equipment purchases
  - Absence of usage guidelines

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## General Conditions – Project Management Labor Costs

- › Risk analysis red flags
  - Labor rates are too high
  - No weekly billable hours cap on exempt employees
  - No adjustments for vacation & holiday hours
  - No estimated staff budgets
  - No definition of role & responsibilities
  - Lump-sum line item budgets
    - › Lump-sum project management budget
    - › Lump-sum burden rates

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## 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.

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## 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
  - Excessive materials ordered
  - Excessive material storage charges
  - Credits not received for returned materials

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## Material Costs

- › Audit
  - Compare material purchased with architect specifications
  - Verify shipping address on all materials charged to the job
    - › Request proof of delivery to the jobsite for all materials that are originally shipped to the GC's shop or off-site storage
  - If the GC uses blanket purchase orders to purchase items in bulk, request validation such as a shop ticket for all items charged to the project
  - Prepare owner direct materials control schedule
    - › Reconcile total labor & materials billed with contract value. Excess charges can represent cost shifting
  - Verify subcontract terms hold GC responsible for commodity price increases

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## 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

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## 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

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## 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

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## Other Things to Watch For

- › Subcontractor payments
- › Contingency usage
- › Markup on markup

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# Questions?

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