



THE DANGER BURIED WITHIN:

Identifying Red Flags in Construction Contracts

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October 10, 2019

OBJECTIVES - TO HELP YOU:

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



Value of Construction Audits

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 and contractor
 - Potential construction cost recovery

“BUT, WE HAVE CONSTRUCTION MANAGEMENT FIRMS OVERSEE OUR PROJECTS”

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

“BUT, WE WORK WITH THE SAME GC AND HAVE NEVER HAD ANY ISSUES OR COST OVERUNS”

- 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 and/or quality used in order to limit costs?

“BUT, THE GCs WE USE HAVE 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 and GC/architect
 - Excessive change orders/scope changes
 - Math errors

EXAMPLE

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

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

OTHER COMMON SCOPES

- **Contract review** ensures the clear definition of:
 - Roles and responsibilities
 - Allowable and non-allowable costs
 - Financial terms
 - Potentially ambiguous or contradictory terms or clauses
 - Cost of work
 - General Conditions
 - Shared savings calculation, if applicable
 - Owner's right to audit

OTHER COMMON SCOPES

- **Limited scope**
 - Process/control review
 - Change Order review
 - Pay app review



Risk of Various Contract Types

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

LUMP SUM CONTRACT

- Benefits

- Known financial commitment
- Less administrative burden for owner
- Less risk of scope creep and budget overage

- Disadvantages

- Potentially higher markup by GC for unforeseen contingencies
- Limited visibility into project costs which can make it easier to conceal non-compliance 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 and/or cost support to the pay app
- But, there can be change orders, which should be scrutinized
 - Contractor may add OH&P, added General Conditions, performance and payment bond costs, and insurance
 - Contract needs to define what of the above costs will and 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

GMP CONTRACT

- Benefits

- Not to exceed price
- May benefit from value engineering and 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 and administration by owner
- Project complexity can create opportunities for abuse

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 and supporting documentation need to be audited to ensure costs are allowable and there is no cost shifting

T&M AND COST PLUS CONTRACTS

- Benefits

- Can provide transparency into costs
- Easy to pivot if project specifications change

- Disadvantages

- More project management and administration by owner
- No incentive for GC to be efficient
- No incentive for GC to reduce costs

T&M AND COST PLUS CONTRACT RISKS

- Business terms and 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 and what is not reimbursable is important
- Monthly pay apps should include detailed support, and include subcontractor invoices as well



Hidden Profits

COST SHIFTING

- Non-authorized transfer of costs from non-reimbursable cost centers to reimbursable cost centers
- Why does cost shifting occur
 - Poorly defined contract terms
 - Contract misinterpretation
 - Misunderstanding/ poor communication between GC and owner
 - Weak and/or poorly implemented controls
 - Carelessness and errors
 - Fraud

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 and equipment rate burdens
 - Overtime charges from unrelated projects
 - Comingled construction management and self-performed work
 - Comingled contingency and allowance budgets

CHANGE ORDERS

- Change orders represent the most significant financial risk in a construction project
 - Unwarranted change orders
 - Inflated pricing for change orders

CHANGE ORDER RISKS

- 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

CHANGE ORDER RISK

- 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”

CHANGE ORDERS

- Contract should include detailed requirements for estimating/pricing and 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 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

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.

PAY APPLICATIONS

- Common findings
 - Fee computation errors
 - Overbilling
 - Unauthorized budget allocation
 - Roll forward errors
 - Missing documentation
 - Overcharging the General Conditions budget

INFLATED PAY APPS

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

GENERAL CONDITIONS

- General Conditions are the contractor's compensation for overhead, indirect project costs and direct costs not already accounted for in the SOV
- Well defined cost and service coverage in the contract is key to minimizing disputed General Conditions costs

GENERAL CONDITIONS

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

GENERAL CONDITIONS

- Typical non-allowable General Condition items
 - Project management software
 - Profit sharing
 - Home office expenses
 - Company owner/principal labor and 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

- Risks

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

GENERAL CONDITIONS

- Contract should include detailed requirements on what is considered allowable and unallowable
 - 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 and communication costs

GENERAL CONDITIONS

- Contract provisions and 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 and stated as a flat daily rate or mileage rate

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

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 and holiday hours
 - No estimated staff budgets
 - No definition of role and responsibilities
 - Lump sum line item budgets
 - Lump sum project management budget
 - Lump sum burden rates

CONTRACTOR OVERHEAD

- The 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.
- ROT: Only costs that occur at the project site should be reimbursable

MATERIAL COSTS

- Contract and plans should include detailed requirements as to what material is requested and 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

MATERIAL COSTS

- Audit
 - Compare material purchased with architects 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 offsite 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 and materials billed with contract value. Excess charges can represent cost shifting
 - Verify subcontract terms hold GC responsible for commodity price increases

EQUIPMENT COSTS

- Contract and 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

EQUIPMENT RENTAL COSTS

- Contractors do not necessarily own all equipment they need on a project, so they rent some equipment
- Equipment rental costs are passed on to the owners through the General Conditions portion of the pay app
- If contractors do own the equipment, they may invoice the owner for the use of that equipment, but at what rate
 - Should be market rate as stated in a recognized “book”
 - Know what local rates are and negotiate downward if appropriate

EQUIPMENT MAINTENANCE COSTS

- Contractors may attempt to charge the owner for the cost of repair and 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 and not passed on separately to the owner

LABOR & LABOR BURDEN

- Labor burden percentage used is incorrect
- Labor burden includes non-reimbursable items
 - Bonuses, education, etc.
 - Contract should define what is allowable in labor burden build up
- Unemployment tax still charged after maximum reached

SUBCONTRACTOR PAYMENTS

- Back charges not passed through to owner
- Markups calculated incorrectly
- Duplicate Change Orders to GC
- Errors in pay apps

CONTINGENCY USAGE

- Request pricing support/authorization for all contingency use
- Verify authorization
- Verify items do not appear to be duplicate scope
- Reconcile authorized contingency use to pay apps and contractor progress reports

MARKUP ON MARKUP

- When self-performing work, some contractors may attempt to take a markup on a markup
 - Contractor bills the owner a self-performance fee and then takes the contractor fee on top of that amount
 - On change orders, contractor takes a markup on the OH&P for the Sub, and takes a contractor's fee on the contractor and the sub OH&P

Questions?

Thank You!

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