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## 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 trade off 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 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 also 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 of 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 it's 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.

## **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 includeable 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**

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.