



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 actually 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 clean up 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, like side deals with insurance and bonding companies. Recently we came upon one contractor's internal check list 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 check list 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 check list 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 check list 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 to 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.