Preconstruction Contract Review

Minimize billing interpretation issues

By Curt Plyler, CFA, CCA

As a construction project moves from an idea towards inception, the owner, contractor and their attorneys work together to create a construction contract designed to meet their mutual interests. Much effort and expense go into this process, which are necessary given the potential risk exposures. However, once the contract is set for execution, an essential step to minimizing future disputes is often omitted. A preconstruction contract review (PCCR) can assist in identifying and mitigating many issues arising from differing contract interpretations.

Guaranteed maximum price (GMP) contracts are often used by owners and contractors to move forward on construction projects that are not fully defined. A fair price for a project should leave both the owner and contractor satisfied at project completion. In a GMP contract, the contractor is normally paid the cost of the work plus a fee. Agreeing on a definition for cost is paramount. A PCCR establishes proper cost expectations at project inception.

The contract is often rather simplistic in defining reimbursable and nonreimbursable costs, and the true cost incurred is not as clear as one might expect. The PCCR review supports and clarifies the efforts of the owner, contractor and attorneys in ensuring the underlying financial intent of the contract is met.

The contractor will likely want to use predefined rates to bill labor, leased equipment, insurance, information technology, and other incurred costs for convenience and assurance that its costs will be fully covered. Using predefined rates is considered reasonable, but the owner should want a review to validate that the rates to be used to charge the project approximate the actual costs incurred.

Review areas

1. Contract language
2. Labor billing methodology
3. Contractor-owned equipment rates
4. Defined rates for other items
5. Budget for daily/interim cleaning
6. Required documentation

Contract language

Ideally, a PCCR is done prior to contract execution. The contract is designed to eliminate ambiguities, but the complexities of a large construction project often leave the various parties with different understandings and assumptions related to project billings.

Your work should complement the work of the attorneys for the owner and the contractor. The attorneys are focused on the contract to minimize their respective party's risk, and the auditor seeks to minimize the potential for future billing disputes. These disputes often involve billing methodologies that may not match the contract's language.

You will review the draft contract language and identify potential areas of concern. Place specific emphasis on analyzing the contract language that defines reimbursable and nonreimbursable costs. Take care to ensure these definitions are consistent with other project documents, including the request for proposal, response to the request for proposal, contract assumptions and clarifications, and GMP workbooks.

Labor billing methodology

Labor is the largest component of the general conditions costs and should be reviewed in detail. The contractor is

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entitled to recover the cost of payroll taxes, insurance and customary benefits.

Labor burden costs are often recovered through a labor burden billing rate applied to base wages. Since these costs will vary depending on who is assigned to the job, an estimated labor burden is often billed to the project. You should examine the proposed job roster and review employee payroll records. The review ensures that the base wages billed are the actual wages paid to the employees.

Additionally, ensure that the labor burden is supported by actual benefit and payroll tax costs for both regular and overtime hours worked by the contractor's hourly and salaried workforce. Labor burden components not applicable to overtime hours should be excluded from the burden rate.

Some contractors use composite labor billing rates that are inclusive of base wages and labor burden to charge the project. Review the contractor's payroll records to ensure that the rates are representative of actual costs incurred.

Validate burden or billing rates:

- Confirm base wages earned by verifying each employee's salary in the contractor's payroll system.
- Refer to the contract, which should define the applicable labor burden or billing rate components:
  - Determine that the burden and billing rates include the typically expected components: Social Security/Medicare (FICA), Federal Unemployment (FUTA), State Unemployment (SUTA), and 401(k) matching costs. Statutory rates apply to FICA, FUTA, and SUTA.
  - Request that the contractor provide supporting documentation to justify the cost of other components included in the burden or billing rates.
- Ascertain that items such as computers, vehicles and living allowances are excluded unless specifically allowed by the contract. If these items are reimbursable, the items should be billed separately, not as part of the labor burden or bill rate.

Contractor-owned equipment rates

Many contractors lease their own equipment to the project. During your PCCR, determine or validate:

- Fair market value of each item of equipment upon scheduled arrival on the project site
- The basis of components of the rate (e.g., fuel, oil, lubricants) to be charged for each item of equipment
- The aggregate amount allowed to be charged for each item of equipment, which should not exceed a predefined percentage of each item's fair market value
- Any other charges to be billed separately and directly for equipment

The rates should be supported by a respected industry source, that provides average rental rates for construction equipment from hundreds of rental distributors nationwide, such as the *AED Green Book*[1] and *RSMeans*.[2]

To use the *AED Green Book* and *RSMeans*, you will need to determine the appropriate:

- Category of equipment
- Model of equipment
- Rate (i.e., hourly, daily, weekly or monthly)
- Regional rate adjustment

[1] Published by Associated Equipment Distributors, Oak Brook, Ill., or available at https://equipmentwatch.com/retail-rental-rates/
[2] https://www.rsmeans.com/

Defined rates for other items

Insurance – Contractors will often insert contract language allowing insurance to be charged at a stated rate, or they will bill the coverage at a rate despite contract language that states only the premiums related to the project are allowed. Contractors procure certain lines of insurance for their whole business, and their stated insurance rates are often inclusive of excess coverages and home office insurance costs beyond what the owner requires.

Some owners may view these billing approaches as unfairly charging their project for unnecessary items. However, insurance rates built in this manner often allow the contractor to provide, and the owner to benefit from, the required coverages at a lower cost than if project-specific policies were procured. Like the leased equipment and labor billing rates, the owner must understand and agree on the items comprising the insurance rate in the contract.

Information technology (IT) – Similar to insurance, many contractors attempt to insert contract language specifying a rate—a predefined percentage or an amount per labor hour of work—for IT. Alternatively, the contractor will charge a rate despite contract language specifying the billing of actual cost incurred for direct project-related expenses.

You need to review any IT billing method that utilizes a rate to ensure both parties agree that the components comprising the rate are reimbursable. IT expenses incurred at the construction site are usually reimbursable.

Home office IT expenses often support the project site, and the contractor will want to recover at least some of the costs. An upfront discussion and agreement on which IT components are and are not reimbursable is valuable to both the owner and contractor. IT components should not be billed directly if included in a predefined rate. Additionally, any rate based on a charge per work hour should allow regular time wages but not overtime.

Other items – Other items like document reproduction and retention are often charged to the project with predefined rates. You should request during your PCCR that the contractor provide a list of all rates to be used in place of actual costs. Ensure that the rates are representative of actual cost incurred. For example, a contractor's recordkeeping costs may not be identifiable to a specific job. However, the costs can be allocated on the basis of revenue to the project's percentage of the contractor's overall annual revenue.

Budget for daily/interim cleaning

Daily or interim cleaning charges can be a contentious issue during the project. Most subcontracts require subcontractors to maintain a clean job site. If the contractor is self-performing work, keeping their portion of the job site clean should be in their scope.

If the contractor is not self-performing work on the project, the owner may perceive a duplicate billing when daily or interim cleaning charges are billed to the project. Subcontractors should be back charged for any further cleaning required because of their work. Sometimes determining the responsible party for cleaning is difficult, especially when common areas are used by multiple subcontractors.

During your PCCR, review the daily/interim cleaning budget and verify the owner's agreement. The budget should be capped to prevent abuse.

Required documentation

During your PCCR, evaluate the documentation required to approve owner change orders, payment applications, and allowance/contingency usage.

- Change orders should be fully supported, including templates specifying allowable markups for labor, equipment and materials.
- Allowance and contingency expenditures should be reviewed with the owner prior to the incurrence of these costs. Utilizing a no-cost change order to track usage provides the proper transparency to the owner.
- Each monthly payment application should be fully supported with subcontractor payment applications, invoices for all expenditures above a predefined threshold, and a job cost report inclusive of a reconciliation for that billing.
- Monthly labor and leased equipment reports should be provided by the contractor to ensure visibility is provided for the individuals and equipment moving on and off the project.

Interim and closeout reviews

You should begin validating the contractor's actual billings to the owner starting at project inception. On large projects, *Request that the contractor provide a list of all rates to be used in place of actual costs.*

interim audit reviews are recommended for every six to nine months of activity after project inception and the PCCR.

The reviews should validate whether the contractor has billed in a manner compliant with the understanding reached during the PCCR. Additionally, staff turnover, both with the contractor's and the owner's project management teams, often leads to misunderstandings regarding the agreed-upon billing methodologies. Interim audit reviews should mean your closeout audit will only identify minimal findings in the absence of large clerical errors.

Conclusion

Financial oversight of a construction project can be significantly enhanced by a PPCR because of the elimination or minimization of potential billing interpretation issues. The owner benefits by avoiding a negotiation for a partial credit later in the project for a difference of interpretation. The contractor has clarity on the rules for billing. For both, bad feelings can be avoided that may arise if the owner questions the contractor's billing methodologies later in the project. **NP**

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