

# *Cost Plus Construction Contracts*

## **Objective:**

To determine if overcharges have been made on the project and if so to obtain refunds or credits from the contractor. Specific risks are presented at the beginning of each section. Also presented at the beginning of each section is suggested contract language that could help lessen the risk of loss.

Contractor charges usually fall into the following categories:

- Labor & Benefits
- Materials
- Subcontractor Costs

Step	Audit Procedure
	<p><b>General Procedures</b></p> <p>Obtain a copy of the contract between the contractor and your company. Review it and develop an understanding as to what costs are reimbursable and what costs are not. Determine that the contract was properly approved and executed (did the person signing the contract have the authority to do so?) .</p> <p>Obtain an understanding of the contractors project cost accounting system and determine if it appears adequate to properly capture costs.</p> <p>Reconcile contractor's payment requests to the project cost accounting system.</p> <p><b><u>Labor &amp; Benefits</u></b></p> <p><b>Charges for non-reimbursable personnel.</b></p> <p>Unless otherwise provided in the contract, charges for contractor labor should be limited to the contractor's field personnel. Charges for home office personnel should not be reimbursable costs and should be covered by the contractor's fee.</p> <p>Suggested Contract Language:</p> <p>"Charges to Cost of the Work reimbursable will be limited to actual costs of Contractor's salaried construction personnel stationed in the field. The Owner and Contractor agree that the following positions represent the maximum authorized field office staff salaried positions which will be considered reimbursable under the terms of this contract unless subsequently changed for reasons approved by the Owner by a formal change order to the Contract:</p> <p>One Field Project Manager  One Project Superintendent  One Assistant Superintendent  One Project Engineer  One Time Keeper or One Clerk of the Works</p>

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	<p data-bbox="326 144 634 180">One Project Secretary</p> <p data-bbox="326 218 1018 506">Reimbursable costs for the above individuals will begin no earlier than the time they report for work at the field office after the official construction start date. Charges for these individuals will be considered non-reimbursable (1) at the time they conclude their service at the field office, or (2) 60 days after substantial completion which ever is earlier.”</p> <p data-bbox="326 583 558 619">Detailed Testing:</p> <ol data-bbox="326 657 1018 945" style="list-style-type: none"> <li data-bbox="326 657 1018 800">1. Review contract to determine those contractor employees who are considered reimbursable and those that are non-reimbursable (usually company officers).</li> <li data-bbox="326 840 1018 945">2. Review payment requisitions and determine that no hours are charged for non-reimbursable contractor personnel</li> </ol>
	<p data-bbox="326 1026 902 1062"><b>Labor charges in excess of actual cost.</b></p> <p data-bbox="326 1100 1018 1243">Needless to say, excess labor charges, either in hours or rates should be tested for. A right to audit clause that allows the Owner to review the Contractor's payroll records would lessen this risk.</p> <p data-bbox="326 1281 548 1316">Detailed Testing</p> <ol data-bbox="326 1354 1018 1755" style="list-style-type: none"> <li data-bbox="326 1354 1018 1497">1. From the payment requisitions, select a sample of contractor employees for testing. Make sure selection covers payment reqs from all phases of the project.</li> <li data-bbox="326 1537 1018 1642">2. Obtain contractor's payroll records for the periods selected and trace hours and rates from billings to payroll records.</li> <li data-bbox="326 1682 1018 1755">3. For selected employees, trace payroll register summary information to copies of W-2's.</li> </ol>

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	<p data-bbox="321 142 1015 180"><b>Non-reimbursable or unpaid bonuses charged.</b></p> <p data-bbox="321 218 1015 432">As noted in (1), above, home office labor is non-reimbursable. Additionally, any bonuses paid to home office personnel should also not be chargeable. Any charges for bonuses for field employees should be limited to bonuses actually paid.</p> <p data-bbox="321 474 545 512">Detailed Testing</p> <ol data-bbox="321 550 1015 764" style="list-style-type: none"> <li data-bbox="321 550 1015 617">1. Determine if the contract allows contractor bonuses to be charged to the project.</li> <li data-bbox="321 655 1015 764">2. If bonuses are allowed, make sure that bonuses were actually paid to the employees at the rates charged.</li> </ol>
	<p data-bbox="321 840 852 877"><b>Charges for Unpaid Overtime Hours</b></p> <p data-bbox="321 915 1015 1096">We have noted instances where contractors charge for overtime hours worked by exempt employees who are not paid for the overtime worked. These charges may be allowable if the contractor has a policy of compensating time off.</p> <p data-bbox="321 1138 618 1176">Suggested Language</p> <p data-bbox="321 1213 1015 1461">"Overtime wages paid to salaried personnel (if approved in advance in writing by the Owner) will be reimbursed at the actual overtime rate paid to the individual. No time charges or other reimbursement for overtime hours worked on the project will be allowed if the individual is not paid for the overtime worked."</p> <p data-bbox="321 1503 553 1541">Detailed Testing:</p> <p data-bbox="321 1579 1015 1717">As part of the testing above for labor charges in excess of cost, ensure that any overtime hours billed were actually paid to the employees under review.</p>
	<p data-bbox="321 1797 1015 1835"><b>Non-reimbursable Overtime Premium Charges</b></p>

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	<p>Suggested Language</p> <p>"Any overtime premium or shift differential expense to be incurred by Contractor for hourly workers shall require Owner's advance written approval before the incremental cost of the overtime premium or shift differential will be considered a reimbursable cost. If the contractor is required to work overtime as a result of an inexcusable delay or other coordination problems caused by the Contractor or anyone they are responsible for, the overtime premium and/or shift differential expense portion of the payroll expense and related labor burden costs will be considered non-reimbursable costs."</p> <p>Detailed Testing</p> <p>For any overtime charged to the project, ensure that the company representative authorized the working of overtime.</p>
	<p><b>FICA, State &amp; Federal Unemployment Taxes</b></p> <p>These payroll taxes all have annual limitations on the wages subject to taxation. When calculating the cost of these taxes, some contractors fail to adjust their burden rates for these limitations. Additionally, some contractors fail to take into account that some of their field employees may be working on more than one project at the same time.</p> <p>Suggested Language</p> <p>"Proper consideration shall be given to annual limitations on wages subject to such payroll taxes and the worker's applicable percentage of annual wages attributable to this project when computing payroll taxes chargeable as Cost of the Work."</p> <p>Detailed Testing</p>

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	<ol style="list-style-type: none"> <li>1. As part of the review of the contractor's cost system, determine if the system properly gives effect to the annual wage limitations for the various payroll taxes. If not, determine if the contractor adjusts his billings to reflect this.</li> <li>2. For employees selected for payroll testing elsewhere, determine the wage cutoff levels for the various payroll taxes.</li> </ol> <p>If the contractor is relatively unsophisticated, they may be calculating an overall payroll burden rate that is applied to all employees. Again, this overall burden rate should take into account the annual caps.</p>
	<p><b>Worker's Compensation &amp; General Liability Insurance</b></p> <p>Some larger contractors may also have affiliates that are in the insurance business. If worker's comp or general liability insurance is purchased from these affiliates, it should be disclosed to the Owner. Additionally, if the Contractor intends to self insure, this should also be disclosed.</p> <p>Suggested Language</p> <p>"If the contractor is self-insured to any extent or purchases insurance through any subsidiary, affiliate, parent company, etc., such arrangement must be disclosed to the Owner in writing before such costs will be considered reimbursable under the terms of this agreement. The contractor's method for determining actual costs of such insurance coverage will be detailed to Owner in writing in advance and will be subject to Owner verification. The costs of such insurance premiums which will be considered reimbursable will be limited to that charged by third party insurance companies for similar coverage. Proper consideration will be given to cost reductions available due to favorable experience modifiers, volume discounts, trade discounts, dividends, etc."</p>

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	<p>If worker's compensation and general liability insurance costs are included in payroll burden, these costs should be reviewed as part of the review of payroll burdens.</p>
	<p><b>Incorrect Charges for Union Benefits</b></p> <p>The cost of certain union benefits are an expense of the worker and not of the Contractor and should not be considered a reimbursable cost. Union dues and vacation deductions are examples of some of these costs. The contractor's share of union charges are usually billed to a project through the payroll burden rate. Additionally, the cost of union benefits should only be applied to straight time. It should not be applied to the premium portion of overtime.</p>
	<p><b>Payroll Burden</b></p> <p>Certain payroll related costs (pension, profit sharing, ESOP, Medical/Dental, Life Insurance, Relocation, Payroll Taxes, etc.) and other costs (Worker's Compensation and General Liability Insurance) are sometimes charged to a project through a payroll burden rate that is applied to project labor. Many of these costs are based on estimates and assumptions that should be adjusted for during the project. Contractors should be required to provide details on their burden rate calculations during the bidding phase.</p> <p>Suggested Language</p> <p>"Any payroll burden related costs to be reimbursed shall be subject to advance written approval by Owner to be considered reimbursable. Costs typically falling into this category include but are not limited to pension, employee stock option plans, bonuses, medical &amp; dental benefits, life &amp; accident insurance, etc. The contractor shall be required to submit a detailed breakdown of all such payroll costs along with a representation as to how the proposed actual billable cost will be computed. Such information must be reviewed and approved in writing by the</p>

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	<p>Owner before Contractor may include such items as billable costs. During the job and prior to contract close-out, appropriate adjustments will be made by Contractor to account for increases or decreases in actual costs."</p> <p>It is very important to get the details of what is in a burden rate before agreeing to the rate. Some contractors improperly include home office overhead items in the calculation (e.g. property insurance, office supplies, rent, property taxes, etc.) . These items should be paid out of the contractor's profit.</p> <p>Depending on the contract, overages in the burden rate may or may not be recoverable.</p> <p>Detailed Testing</p> <p>Obtain the contractor's calculation of the payroll burdens in use and review. Be on the lookout for the following items:</p> <p><b>FICA, FUTA, FUI, SUI, etc. exceed statutory limits.</b></p> <p>Determine if the contractor's cost accounting system is able to calculate payroll tax and insurance amounts for each employee. If yes, determine if that feature has been enabled. If no, see b) below.</p> <p>Determine if the burden rate used by the contractor has been adjusted to reflect the statutory limits.</p> <p><b>Worker's Compensation:</b></p> <p>Worker's comp insurance premiums are subject to adjustment (up or down) based upon the contractor's past history. Usually there is an experience modification factor and also some type of discount.</p> <p>Be sure that the rate charged reflect any and all adjustments to the base rate.</p>

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	<p>Rates vary based upon the class of worker. Steel worker's have a very high rate while office clerks have a very low rate. Some contractors calculate a straight composite rate based upon the classifications of all employees on the jobsite without weighting the rates to reflect the mix of trades on the site.</p> <p>Make sure that the calculation takes into account the mix of trades at the jobsite.</p> <p>Other Insurance:</p> <p>Make sure that the contractor is only charging the company for the insurance that is allowed under the contract. Usually the only insurance that is charged is general liability insurance, equipment floaters, and auto insurance. Items such as property insurance of the contractor's home office, fidelity bonds on employees, etc. are part of the contractor's overhead and should not be charged to the project.</p> <p>General Liability Insurance:</p> <p>The premium for g/l insurance is usually based on the annual expected revenue of the contractor. Many contractors convert this to a payroll burden by dividing the premium by the expected payroll for the year. If the contractor incurs less payroll than estimated than he has undercharged his clients for insurance. If he incurs more payroll than expected, he will overcharge his clients.</p> <p>To determine if the company has been overcharged:</p> <p>1) Calculate the percentage of the contractor's revenues represented by our project:</p> $\frac{\text{Total Billings to the Company}}{\text{Total Client Billings}}$ <p>2) Multiply this % by the insurance premium. This is Company's share of the premium.</p>

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	<p>3) Compare this to premiums billed.</p> <p>Another thing to be aware of is the amount of insurance coverage. Included in the contract documents should be a section showing the required insurance coverages. G/L is usually set at \$10mm.</p> <p>Review the insurance premium billing and burden calculation and make sure that we are not being billed for excess insurance. We only require \$10mm. If the contractor want additional insurance, he should pay for it himself.</p> <p><b><u>MATERIALS</u></b></p> <p>Most construction contracts specify that the contractor is responsible for purchasing the construction materials: structural steel, concrete, pipes, etc.</p> <p>In testing material purchases cost we need to look for the following:</p> <p>Evidence that a competitive bid process was followed on major material purchases.</p> <p>Material charges on the contractor's invoice are supported by vendor invoices, delivery tickets, etc.</p> <p>Material charges on the contractor's invoice are supported by canceled checks.</p> <p><b><u>SUBCONTRACTORS</u></b></p> <p>Work subcontracted to others should be covered by subcontracts. For major subcontracts:</p> <p>Determine that subcontractor costs billed represent subcontractor costs incurred by the contractor. Trace to canceled checks.</p> <p>If subcontractor costs billed include payment or</p>

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	<p>performance bonds, determine that bonds were actually obtained.</p> <p>Review subcontract documentation for credits issued to subs which were not passed along to the owner.</p> <p>Inquire if any of the subs or suppliers and related to the contractor in any way. The general liability insurance policy usually lists all subsidiaries, etc. that are covered by the policy.</p> <p><u>Equipment Rental</u></p> <p>Renting construction equipment to owners is a lucrative sideline to many contractors. Equipment purchased long ago and carried on the books at zero cost are being rented out at new equipment rates. On some contracts, the total rentals paid by owners approach and sometimes exceed the purchase price of the equipment being rented. Some equipment is purchased for the contractors by the owners through the monthly rental payments because of undisclosed lease/purchase agreements between the contractor and the equipment distributor.</p> <p>It is important to remember that we are talking about a cost plus contract here. Any charges by the contractor should reflect his cost and any profit is included in the markup percentage. If a contractor's rental rates include profit, the owner ends up paying profit on top of profit.</p>
	<p><u>Rental Rates</u></p> <p>It is almost impossible for an owner to determine if the rental rates being charged by a contractor are fair unless he is provided with a description of the equipment, including its age. Once this is provided, comparisons to market or other contractors can be made.</p> <p>"Contractor owned equipment shall mean all tools and equipment owned directly by the Contractor, the Contractor's affiliates, parent company or any other related party.</p>

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	<p>Proposed rental rates and related fair market values for Contractor owned equipment shall be submitted to and approved by the Owner prior to being used in connection with the work. The projected usage for each piece of equipment and the estimated total rentals shall be submitted to the Owner so that an appropriate lease vs. buy decision can be made".</p> <p>The above can be made stronger by including language that limits rental rates to no more than 75% of the rates published by the Associated Equipment Distributors (AD).</p> <p>Ask the contractor if he has a copy of the "Means Building Construction Cost Data" book. This is a comprehensive listing of construction costs. If available, compare rental equipment costs to the book.</p>
	<p><b>Aggregate Rental Limitations</b></p> <p>We have seen time and again where the aggregate rentals paid for a piece of equipment or a motor vehicle far exceeded its purchase price.</p> <ul style="list-style-type: none"> <li>• \$21,000 for a small pickup for 3 years.</li> <li>• \$1,500 for a fax machine worth \$300</li> </ul> <p>"The aggregate rentals chargeable for each piece of Contractor Owned equipment shall not exceed _____% of the fair market value of such equipment at the time of its commitment to the Work. The original purchase price, date of purchase, and proposed fair market value for each piece of equipment projected to be used on the project will be supplied to the Owner for approval. Such aggregate rental limitations will apply and no further rentals shall be charged even if a piece of equipment is taken off the job and replaced with a similar piece of equipment.</p> <p>The fair market value for equipment referred to in this contract shall mean the estimated price a</p>

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	<p>reasonable purchaser would pay to purchase the used equipment at the time it was initially needed for the job. "</p>
	<p>Lease/Purchase Agreements</p> <p>It is not uncommon to find that a contractor does not own the equipment that they are renting to the owner but are purchasing the equipment through a lease purchase agreement. The lease payments are being made by the owner through his monthly rental payments. At the end of the project, the equipment becomes the property of the contractor. The following clause will assure that the owner gets proper credit for the equipment.</p> <p>"Any lease/purchase rental agreements between the Contractor and a third party shall be disclosed to the Owner. If any equipment is purchased by the Contractor under such an agreement and where any of the lease/purchase rental charges were charged to the Owner as reimbursable job costs, appropriate credit adjustments to job cost will be made for the fair market value of the equipment at the time it was last used on the job."</p>
	<p>Maintenance Costs on Contractor Owned Equipment</p> <p>Make sure that only routine repairs and maintenance are billed to the owner and not any capital repairs.</p> <p>"All costs incurred for minor maintenance and repairs shall be reimbursed at actual cost. Such costs include routine and preventative maintenance, minor repairs and other incidental costs. Repairs and/or replacements of a capital nature are considered to be covered by the rental rates. Major repairs and overhauls are not considered routine and ordinary, consequently, such costs are not reimbursable and are intended to be covered by the rental rates."</p>
	<p><u>Rebates, Discounts, &amp; Refunds</u></p>

<b>Step</b>	<b>Audit Procedure</b>
	<p>Normal cash discounts tend to be in the 2% range. Most contracts allow Contractors to keep cash discounts on the theory that purchases are made out of pocket by the Contractor and then reimbursed by the Owner. However, there is a trend towards "excessive" cash discounts in the 10% - 20% range. These discounts should be considered trade discounts which normally accrue to the Owner.</p> <p>"Normal cash discounts (2%) obtained on payments made by the Contractor shall accrue to the Contractor. Trade discounts, rebates, refunds, and amounts received from the sale of surplus materials and equipment shall accrue to the Owner, and the Contractor shall make provisions so that they can be secured. Cash discounts that are excessive (10% to 20%) are considered trade discounts and shall accrue to the Owner."</p>
	<p><b>Change Orders</b></p> <p>Review the contract and determine how the dollar effect is to be calculated.</p> <p>Review change orders and ascertain that the dollar impact is calculated according to the contract.</p> <p>Summarize change orders and trace to latest request for payment.</p>