

News, Notes & Commentary

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Deductive Fee on Credit Change Orders

A surprising number of contracts that we review or audit are silent on deductive fee on credit change orders. Even when the contract is exceedingly clear that both additive and deductive change orders should have a fee add or fee credit contractors regularly ignore the credit provision. Indeed this failure to give back fee on credit change orders is one of our most common audit findings.

Assuming that your contract is not one of the explicit ones, let's examine the equity of a fee give-back. Contracts and contractors typically quote a fee, which has both overhead and profit elements as a percentage of construction cost. In reality, the return the contractor needs to cover overhead and make a profit is not dependant on construction value but rather the contractor's deployment of assets. For most contractors these assets are its ability to manage the construction process or in other words people. If change orders, either additive or deductive, do not increase the construction schedule and do not require more management personnel then any fee change would generally not be warranted. However, the construction industry has seen fit to adopt a standard fee valuation based on construction cost. Certainly there is an advantage to this approach in that any argument about how much overhead and profit individual changes should require is decided in advance by a contract agreement on the fee percentage on change order cost.

Most projects experience change orders. More often than not credit change orders occur at the beginning of the contract when value-engineering options are still being evaluated. Additive change orders soon follow and yet most project's change orders never add to the project schedule or increase the contractor's field management. On a project with a 5% C.O. fee and \$300,000 in additive change orders and \$150,000 in deductive ones the contractor's fee is actually increased by 10% on the net contract value increase if deductive change orders do not have a fee credit.

Obviously, equity would say that if there happened to be net reduction in contract costs due to all change orders on a project then the contractor's fee should be protected. We have seen many owners attempt to protect themselves, in the event that a substantial portion of the project is cancelled, with a provision for contractor fee reduction if the overall contract change order credits exceed 20% or more of the initial contract sum. If you are unsure of how your contract fee should be worded please contact us.

Consultant Reimbursable Costs

A while back we wrote about CADD costs and microcomputer charges by some architects and engineers. We briefly mentioned certain other in-house charges for blueprints, copies, faxes and telephone. We thought it would be a good idea to focus on one common reimbursable expense – in-house copies, and possibly explain how an owner can be overcharged. The following situation occurred recently.



On a large architectural contract for an office building the architect charged 25 cents per in-house copy. The total copy cost over three years was \$55,000. The architect billed for its labor at actual labor cost plus a negotiated multiplier that covered all overhead and profit. Reimbursable costs were to be billed at actual cost with no mark-up.

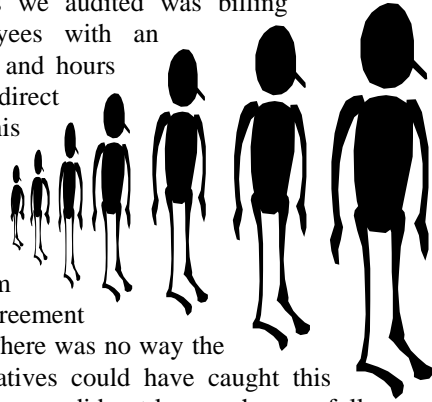
One block away from the architect's office was a copy center offering copies at 5 cents per copy. The architect did not keep records of their actual cost of making a photocopy. Included in the architect's overhead cost was copier depreciation, office rent, electrical bills, and office supplies, including copier paper. Given the facts stated above one could argue for reimbursable copy cost of between 5 cents and 0 cents per page. As a compromise

position we calculated a reimbursable cost of 3 cents per page and asked for a \$48,400 credit. This audit point would be no less valid if the architect had charged 10 cents rather than 25 cents. Ten cents would still have generated a \$15,400 overcharge for the architect.

Hidden Temporary Employees

Many Owners' contracts with design firms call for all markups to be on the direct productive labor of the design firm's employees. Subcontracting work to other firms or hiring temporary workers through temporary agencies is not subject to the same markups as the design firms full-time employees. It is logical that the design firm would have more cost involved with its own employees than with temporary employees. We discovered an interesting way to avoid the limitation on temporary employees.

One of the firms we audited was billing temporary employees with an employee number and hours as if they were direct employees. This practice produced tens of thousands of dollars of extra profit for the firm outside the agreement with the owner. There was no way the owner's representatives could have caught this practice since the owner did not know who was full time and who was a temporary employee of the design firm. Without a complete audit of both the labor and the reimbursable costs for this engineering firm, the overcharge would have been undetected.



apprentice hours was about \$13,000 plus benefits on a very small contract.

On another contract we found that a contractor was using obviously inflated percentages for the labor burden on the labor rates. As an example, they were using 9% for FICA. FICA is of the first 7.65% of an individual's annual payroll cost all over America. Several other categories were overstated and the overcharge for this \$1,000,000 maintenance contract was \$77,000. In checking further we found that all the owner's contracts, both maintenance and construction, with this specialty contractor included inflated rates totaling hundreds of thousands of dollars.

Had the owner audited all maintenance contractors prior to entering into the original contract, many thousands of dollars could have been saved. The cost of pre-contract audits is marginal compared to the potential overcharge by maintenance contractors.

Free!

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 result of different contract clauses. Please call any member of the group for further information.

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Maintenance Contracts

Many of you have maintenance contracts with companies and renegotiate the labor rates periodically. Recently, we were involved with a company who asked us to audit their maintenance contractors before they began to renegotiate these contracts. The results were interesting.

One of the contractors had a category in their rates called "Apprentices". Most specialty contractors use recognized apprentices to do part of the work on maintenance contracts. In this particular instance, there are 6 different pay rates for apprentices ranging from \$7.00 per hour to \$22.00. The "Apprentices" rate was \$22.00 in the contract and all apprentice hours were billed at \$22.00 per hour. Total hours performed by apprentices was about 1/3 of the total hours worked. During the audit we determined that only about 25% of the apprentice hours were worked by the highest paid apprentices. The overcharge for