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¶ 10 Pursuing A Changed Work Claim On Public Works Projects

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This is the second of a two-part article discussing issues facing commercial construction contractors when they perform public works projects. Part One provided background information on the relevant parts of the Federal Acquisition Regulation that construction contractors may encounter, discussed how these provisions get incorporated into construction contracts, identified some issues that arise for construction contractors, and suggested some best practices for construction contractors. This Part Two discusses guidance, as well as pitfalls and tips, for commercial construction contractors when they are preparing price adjustment proposals or requests for equitable adjustments for changed or added work, delay, or disruption (changed work claims) on public projects.

Background—FAR and DCAA Guidance

Most public works projects (e.g., highways, tunnels, bridges) are performed for state and local government agencies. As mentioned in Part One of this series, many state and local agencies have adopted cost principles and rules similar to the FAR, or even reference the FAR directly. Many public projects also have federal funding, which typically brings the federal regulations directly into play (e.g., the cost principles

in FAR pt. 31 and the pricing rules relating to contract modifications in FAR pt. 15.4).

The Defense Contract Audit Agency is the most developed government audit agency that audits contractors. Although DCAA's main client is the Department of Defense, it also advises and provides audit services for other federal agencies. State audit agencies, and consulting and accounting firms retained by these agencies, often refer to the DCAA guidance in evaluating contractors' changed work claims.

DCAA's Contract Audit Manual (DCAM) is published by DCAA and is the most comprehensive source of government audit guidance relating to contractor performance. DCAM chapter 12 contains guidance on auditing contract termination, delay/disruption, and other price adjustment proposals and claims. DCAM chapter 12 supplements guidance found in DCAM chapter 6 pertaining to auditing incurred costs, as oftentimes changed work claims are primarily based on incurred costs.

The balance of this article discusses pitfalls that commercial construction contractors may face in pricing delay and disruption change requests under the FAR cost principles, with DCAA audit guidance in mind.

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Pitfalls and Tips for Changed Work Claims

Be Reasonable

There is sometimes a tendency in commercial settings for contractors to negotiate changes by “going in high” and settling for some lower amount, or “horse trading” recovery on one issue in exchange for conceding another issue. In addition, changed work claims prepared by well-intentioned contractors may use a variety of theories in pricing a request (e.g., loss of productivity based on industry factors, jobsite overhead allocations). The cost impact of various quantum theories can be challenged as unreasonable compared to the costs and variances documented in the job cost report.

These approaches can be dangerous when public funds are involved. As mentioned in Part One of this series, the FAR imposes a standard of reasonableness on contractors that seek cost reimbursement.² In addition, nearly every state and even some municipalities have some form of false claim act modeled after the federal False Claims Act.³ Government agencies, especially at the state and local level, have increasingly used the threat of false claim proceedings in the course of negotiations over major price changes to contracts.

The best advice for contractors is to document a change request clearly, but also to do an overall reasonableness or “sanity check” before submitting the request. One way to do this is by comparing the request to the amount that would be sought under a “total cost” approach for the issues involved. A request that matches or exceeds what would be sought under a total cost approach is a red flag that the pricing may be flawed. Another similar approach is to add the cost of the changed work to both the current contract price and the estimated contract price to determine the final contract margin. A contractor should investigate any anomalies from these comparisons and revise the request as needed, or at least document the reasons for the anomalies.

Get the Data

Changed work claims often rely on calculations that use incomplete project data. A daily rate for jobsite overhead might be based on a typical month, or a loss

in productivity calculation might be based on a percentage applied to the total labor cost in a single cost code or a select group of cost codes. An audit of the change request could show that these calculations are not in line with the project’s recorded cost.

Developments in electronic data tools now make it easier to analyze a contractor’s costs at a granular level. Today, most contractors’ accounting systems can easily download transaction data into a spreadsheet program such as Microsoft Excel. Where previously a cumbersome database program was required to analyze data, a spreadsheet program can accommodate the cost data at a transaction level for nearly any construction project. Such data can then be checked to identify obvious anomalies.

Once the information is reviewed, it can be mined for specific costs that may become the basis of a changed work claim. For example, jobsite overhead costs can be graphed over time to help identify the time-related portion of the costs. Labor costs can often be studied by day and by worker to track the level of effort in particular parts of the project. Often such data can be electronically compared to data from other sources, such as scheduling information or quantities installed. The results can be graphed to support entitlement arguments stemming from changed work, delay, or a disruptive and less-efficient environment.

Clearly Document Direct Costs

The various claim pricing methods, such as total cost, modified total cost, discrete pricing, and measured mile, are beyond the scope of this article. No matter what method is employed, a government auditor will likely spend a lot of time trying to understand, and possibly challenge, the incurred costs that are the basis of the change. Obviously, the better a contractor’s system of accounting for incurred costs under a logical set of cost codes, the better the contractor will be able to withstand such challenges.

In some instances a contractor can identify the changed work and set up specific cost codes to contemporaneously record the costs of the changed work.⁴ However, separate cost codes must be used carefully. The authors have encountered instances in which sep-

arate cost codes were established, but not used effectively, resulting in an erroneously small amount of the costs being recorded in the separate costs codes on a contemporaneous basis. The contractor in such a case may try to include additional incurred costs in the claim by reclassifying costs to the changed work cost codes well after the fact. This defeats the purpose of creating the special cost codes. Conversely, the changed work codes can become “dumping grounds” for unchanged work that may just be over budget. Either way, the incurred costs of the changed work can be misstated and vulnerable to attack by a government auditor.

No matter what approach is used, an audit of a change request with an incurred cost basis will focus heavily on the controls a contractor has in place to define and contemporaneously record costs in a logical system of cost codes.

Direct Costs—Special Considerations

Contractor-Owned Equipment

Certain direct costs present a greater risk of not being recovered than others in construction contracts. For example, contractor-owned construction equipment costs are subject to specific FAR provisions regarding their measurement.⁵ In general the FAR prescribes that “actual cost data” be used for pricing equipment. Although this is the preference, it is almost impossible to account accurately for the “actual cost” of a specific piece of equipment being employed on a contract or allocated to a change or claim.

Perhaps recognizing this difficulty, FAR pt. 31.105(d)(2)(i)(A) permits a contracting agency to prescribe the use of a predetermined rate schedule to compute construction equipment costs. Agencies often use such a “rate manual” for pricing changes in public works projects. Typically these rate manuals prescribe an “operating rate” that includes the cost of fuel, oil and grease, minor repairs, and other costs that are incurred as a function of the equipment being operated. The rate manuals also include an “ownership rate,” which includes the cost of depreciation, the capital cost of owning the equipment, insurance, and major repairs.

Even when the contract is specific about the rate

manual to be used, the parties may dispute how the rates apply to issues such as: documenting the time the equipment was actually “operating” on the changed work; how long it was idle; whether the rate manual⁶ applies to equipment rented from related entities; how to apply regional or other factors in establishing the rates; and duplication of costs recovered in the rates with other costs being claimed.

A contractor should attempt to negotiate a reasonable approach to pricing changes for its owned equipment, including conventions for operating versus idle equipment, how the specific rate will be calculated from the rate manual and the basis of recorded rates in the job cost system.

Self-Insurance Costs

Many heavy-civil contractors self-insure or have captive entities that provide worker’s compensation or other insurances. Generally the government allows the cost of “average losses” (as opposed to specific losses in any one year) and “administrative expenses” for a self-insurance program. The FAR allows the cost of this type of insurance, but it requires a detailed advance approval from the contracting agency if certain thresholds are exceeded.⁷

As a practical matter public works contractors on fixed-price contracts are not required to go through the arduous process of pre-approval of such insurance. The more likely scenario is that a contractor will charge the project based on some internal rate to account for the cost of the insurance program. When such rates are applied to the cost of a change, government auditors will likely question the basis for the rates.

Some contractors address this situation in advance by specifying in the contract the rates that will be applied to changed work (e.g., in the case of worker’s compensation insurance, state-issued “manual rates”). Failing that, the contractor’s best evidence to justify the rate being charged includes the rate that was included in its bid estimate, the historical cost of the self-insurance program, and the comparable cost of obtaining outside insurance in the marketplace.

In practice, self-insurance rates that can be demon-

strated to be comparable to purchased insurance are generally accepted by government auditors.

Subcontractor Costs

A changed work claim by a prime contractor often includes similar claims from its subcontractors. However, since a subcontractor cannot pursue a claim directly against the owner, the prime contractor has a responsibility to evaluate the subcontractor's request prior to sponsoring it to the owner.

Although the level of inquiry and analysis that the prime contractor must perform on a subcontractor request is not clearly defined in the FAR, the DCAM provides that

the prime contractor does not vouch for the accuracy of the subcontractor's claim. Instead, the prime is only required to conduct an inquiry into the claim sufficient to know there is a reasonable basis for the subcontractor's claim and that it is not frivolous or a sham.⁸

A prime contractor's ability to fulfill this requirement can be challenging. Best practices around this issue are to make sure that all relevant prime contract clauses flow down to the subcontractors; require subcontract change requests to be certified to the prime contractor in the same manner that the prime must certify to the owner; and include (and invoke) a thorough audit clause in the subcontract. In addition, the prime contractor should clearly document its review of the subcontractor's request.

Indirect Costs—Jobsite Overhead

Indirect costs can be a major point of contention in a changed work claim that includes claims for delay and disruption. Although not a regulation or law, governmental audit guidance specifically states that jobsite overhead costs are allowable.⁹ Jobsite overhead, as the name implies, includes the costs of running the jobsite, the project manager and onsite staff, the job trailer or office, and utilities.

Despite the simple definition, contractors adopt a variety of approaches in selecting the costs that get recorded to jobsite overhead and other indirect cost accounts. For example, some contractors directly charge for a project executive's time, while other

contractors carry the cost of this effort in a home office overhead account. Some contractors charge superintendent time directly to the work activities; others carry this cost in the jobsite overhead category. In pricing a changed work claim, it is important to understand the components of the jobsite overhead category and develop appropriate approaches to allocating the costs to the change request.

Depending on the nature of the change request, jobsite overhead may be applied as a percentage of direct costs being requested, or on the basis of a daily rate for the compensable days of delay. The biggest potential pitfall in seeking recovery for jobsite overhead is the possibility of double-counting costs. For example, if a claim includes the cost of a specific project engineer as a direct cost, the cost of that engineer should typically be excluded from the pool of jobsite overhead costs that are being allocated based on the delay to the project. The contractor should also consider whether other project engineer costs should also be excluded from the allocated jobsite overhead costs to avoid any potential double-counting.

Another issue that arises in allocating jobsite overhead to a change request is that jobsite overhead often includes unallowable costs such as entertainment, donations, and alcohol, which are expressly unallowable under FAR subpt. 31.205. Although these costs are typically minimal in total, their discovery by a government auditor can damage the credibility of the request and may result in penalties being assessed (for example, if expressly unallowable costs are included in a request for payment or price adjustment).

A contractor seeking recovery for jobsite overhead costs should screen out all potentially unallowable costs and should exercise care in distinguishing between costs that are a function of activity and those that are a function of time. Change requests should be priced accordingly.

Home Office Overhead

Home office overhead costs are the costs of operating the company as a whole: the executive function, accounting, data processing, and other general functions. Most of these costs are recorded in a contrac-

tor's income statement as general and administrative (G&A) expenses. Such costs are generally allocable to projects on a systematic and rational basis, usually based on either total direct project costs or another basis such as direct labor cost.

Three challenges often arise when home office overhead costs are included in a change request. First, a recovery may be barred by the contract, which sometimes states that all of these costs are recovered as part of the markup.¹⁰ Second, if the contract is not clear on this issue, the government may still make the argument that G&A is all recovered in the markup. A contractor's chances of surviving this challenge are improved if it can show that G&A expenses were included separately in the bid. Recovery chances improve further if the contractor also charges projects for its G&A costs on a systematic and rational basis.

The third challenge occurs when contractors charge home office costs based directly on the G&A line-item costs in their corporate financial statements. A government auditor may challenge the cost on the basis that it lacks transparency as to what is included in the pool, for example, interest, entertainment, donations, or other costs that are specifically unallowable under the FAR. To address this situation many contractors, as part of their annual audit, include a supplemental statement itemizing home office costs that are allowable under FAR pt. 31. This approach goes a long way toward preventing an arduous audit of home office costs, and is considered a best practice.

The most important point on recovering home office overhead in a change request is to be consistent and avoid even the appearance of double-counting. For example, a delayed or disrupted project may require the full-time assistance of an estimator from the home office estimating department. If the estimator's costs are charged directly to the claim, care should be taken to ensure that they are not also included in allocations of home office costs.

*Fee or Profit*¹

Contractors are typically entitled to add a profit to most costs included in a changed work claim. The contract may provide for a specific fee or markup on

changed work. Although this markup provision clearly is intended to provide the contractor with profit on the work, it is not always clear on whether it is also intended to fully reimburse the contractor for certain indirect costs. If it is not clear, the government auditor may assert that such markups also include full recovery of home office overhead, or even some jobsite overhead costs that are included separately in the change request.

Contractors should maintain well-documented rationale for the profit percentage contained in a change request. This includes the level of markup in the bid estimate, and to what costs the fee was applied.

Conclusion

Contractors on public works projects are entitled to compensation for owner-caused changes in the work, including the cost of change or added work, delay, and disruption. However, it is important for contractors and subcontractors to understand that successfully resolving such claims with a public owner requires careful documentation of the request under government cost accounting rules. Contractors need to be wary of the risks of overstating these requests as part of a negotiating strategy that, although appropriate in a purely commercial setting, might not be appropriate in the public sector.

ENDNOTES:

²See Part One published in the January 2017 issue, 12 CP&A Rep. ¶ 1. "Reasonableness is the least objective standard in FAR subpt. 31.201. FAR subpt. 31.201-3 does not provide a concrete set of facts and circumstances under which a cost is reasonable, but instead defines a cost as reasonable if it "does not exceed that which would be incurred by a prudent person in the conduct of competitive business."

³1 U.S.C.A. §§ 3729–3733.

⁴In some instances the creation of special cost codes is required. See, e.g., FAR 42.203, Change Order Accounting Procedures.

⁵DCAM 12-802.5a, Equipment Costs On Construction Contract Proposals or Claims.

⁶One of the most common rate manuals is the "Rental Rate Blue Book," which is now offered online by Equipment Watch, equipmentwatch.com/estimator.

⁷See FAR 28.308, Self-Insurance, and FAR 31.205-19, Insurance and Indemnification.

⁸See DCAM 12-605b, Subcontractor Equitable Price Adjustment Proposals or Claims. Also see *U.S. v. Turner Constr. Co.*, 827 F.2d 1554 (Fed. Cir. Sept. 3, 1987).

⁹DCAM 12.802.4b, Construction Job Site/Field Overhead.

¹⁰In a delay situation, despite such contract terms, a contractor may seek to recover disputed extended or unabsorbed overhead, including *Eichleay*-type damages. A discussion of these claims is beyond the scope of this article.

¹¹Although fee is paid on cost-reimbursement contracts and profit is earned on fixed-price contracts, the terms fee and profit are used interchangeably here.