



Disallowed Cost under the ECC

*NEC® Users' Group
Annual Seminar 2014
Workshop*

Disallowed Cost under the NEC3 ECC

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Workshop Agenda



1. Welcome and Introductions (5 – 10 minutes)
2. Disallowed Cost under the NEC3 ECC (20 minutes)
3. Cost Verification (20 minutes)
4. Breakout Exercise: Sub-Group Discussion (30 minutes)
5. Breakout Exercise: Key Findings (30 minutes)
6. Conclusions (5 – 10 minutes)



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1. WELCOME AND INTRODUCTIONS

Simon Matthews, HLG Associates Limited

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Welcome



This Workshop will consider the *definitions and principles* of Disallowed Cost under the ECC, and see the participants engage in *sub-group discussions* that will consider several examples of Disallowed Cost, re-grouping to consider the *conclusions*.

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Learning Objectives



On completion of the Workshop, the participants should be able to:

- define the **key principles** relating to Disallowed Cost in the ECC;
- recognise the **procedures** for dealing with Disallowed Cost in the ECC;
- identify ways that the employer and a contractor can **work within the provisions** for Disallowed Cost in the EC;
- understand some of the **challenges** presented with managing Disallowed Cost under the ECC.

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Workshop Facilitators



Simon Matthews FCMI
MRICS MCIQB DipSurv
DipArb
Director, HLG Associates



Peter Keegan BSc (Hons)
Associate Director, Mace
Limited



Toby Holloway
Director, Mytee Solutions
Limited



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Simon Matthews FCMI MRICS MCIOB DipSurv DipArb



In a career spanning almost 25 years, Simon has worked on programs and projects across a wide range of sectors, for public and private sector clients, including the London 2012 Olympic Games, London Legacy Development Corporation, Parliamentary Estates Directorate, Ministry of Justice, and the States of Jersey.

Simon has substantial experience of working within complex multi-stakeholder environments, in the use of a wide-range of ICT solutions, and most forms of contract including NEC3 and JCT. Simon is also an experienced lecturer and training facilitator.

Simon set-up HLG Associates in 2010 to specialise in delivering procurement, project, commercial and supply-chain management solutions for public-sector clients involved in delivering complex capital and infrastructure projects and programs. HLG Associates are Bronze Members of the NEC3 Users Group. More information about HLG Associates can be found at www.hlgassociates.com.

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Peter Keegan BSc (Hons)



Peter is an Associate Director within Mace's Infrastructure Consultancy Team with a background in commercial management and 20 years' experience working across a broad range of projects and sectors, including the London 2012 Olympic Games, London Legacy Development Corporation, the Wellcome Trust, and Grosvenor Properties.

Peter was responsible for the management, reporting and control of the budget for the whole of the transformation works programme for Queen Elizabeth Olympic Park, working in the central Programme team co-ordinating all aspects of Commercial Management across multiple projects ranging in size from £1m to £220m. Prior to the hosting of the Games, Peter worked as Commercial Manager on the £190m Landscaping & Public Realm project prior to the Games, covering all stages of the landscaping project from cost planning and procurement through to final accounting and close out.

Peter has extensive experience of working both pre- and post-contract with the NEC3 suite of contracts, and is regularly praised for his pragmatic and practical approach to applying the provisions of the contract, when working for his clients. More information about Mace Group can be found at www.macegroup.com.



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Toby Holloway



Toby is a Director of Mytee Limited, an independent specialist commercial cost verification, forensic accounting and auditing company that provides services to major construction and infrastructure clients throughout the construction industry.

Toby has worked in the construction industry as a both Cost Verification Officer and as a senior Cost Manager for almost 15 years. During this period Toby has gained knowledge and experience in various fields working on many prestigious projects, including the London 2012 Olympic Games, Southern Water, London Development Agency and British Nuclear Fuels Limited.

Toby has successfully delivered schemes and is fully versed in audit compliance and management of work streams under cost reimbursable and the NEC3 suite. Strengths include final accounts including producing documentation for final audit to NAO Level of compliance, cost variations, tendering bids, cost comparisons, environmental and health and safety procedures. More information about Mytee Solutions can be found at www.myteesolutions.com



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2. DISALLOWED COST UNDER THE NEC3 ECC

Peter Keegan, Mace Limited



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Key Principles of Disallowed Cost



- To ensure that the Employer pays the correct 'actual' cost to the Contractor.
- Part of the rules governing payment on cost reimbursable options (C, D, E, F).
- Must be clear and unambiguous – cash is at stake!



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Where does Disallowed Cost 'Fit' in the ECC



- Forms a part of the process for calculating the Defined Cost (and therefore Price for Work Done to Date).
- As with most NEC mechanisms, the PM decides if a cost is disallowed following the rules laid out in the Contract.
- PM must be specific in cost identification and reason for disallowing – not a general approach.
- PM will advise the Contractor through the Certification process.

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Definition of Disallowed Cost under ECC Option C



Disallowed Cost is cost which the Project Manager decides:

- is not justified by the Contractor's accounts and records;
- should not have been paid to a Subcontractor or supplier in accordance with his contract;
- was incurred only because the Contractor did not:
 - follow an acceptance or procurement procedure;
 - give an early warning which this contract required.

...

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Definition of Disallowed Cost under ECC Option C



... and includes the cost of:

- correcting defects after Completion;
- correcting defects caused by the Contractor not complying with a constraint on how he is to provide the works;
- Plant and Materials not used to Provide the Works (after allowing for reasonable wastage);
- resources not used to Provide the Works (after allowing for reasonable availability and wastage);
- preparation for adjudication.



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So what's the problem?



Understanding!

- Understanding that just because a cost has been incurred, it may not be paid – even if it is a reimbursable contract.
- Frequently an area of significant disagreement – tangible effect on profitability.



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Records



Clause 52 is supplemented by specific requirements in the Works Information, e.g.

- understand what records are required – must be laid out clearly in the documents and must be supplied;
- on & off hire records + Allocation sheets + Procurement Processes + Purchase Orders + Time sheets + Material quant checks
- go through the process at the start of the Project



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Accounts



- Allow and expect audits (cl 52.3).
- Companies on large complex projects have complex accounting systems.
- Agree cost collection system at the start.
- Agree process for accruals, journals etc.
- Be consistent through the life of the project.
- Internal / cross company charges.

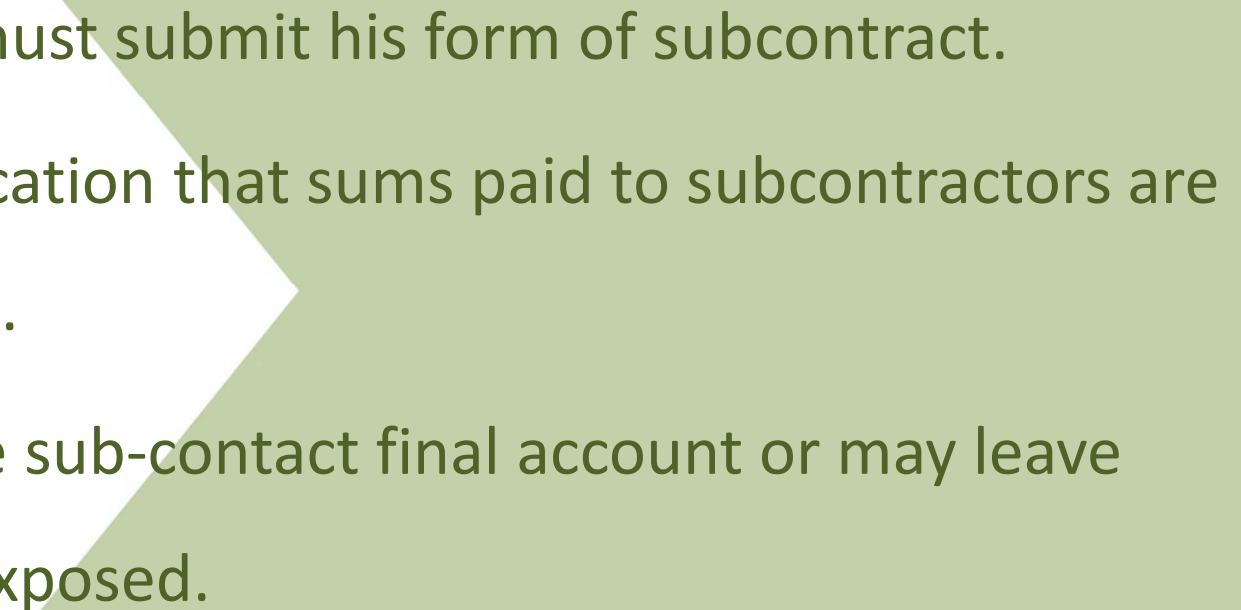


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Should not have been paid to a Subcontractor...



- 
- Contractor must submit his form of subcontract.
 - Allows verification that sums paid to subcontractors are properly due.
 - Check before sub-contact final account or may leave Contractor exposed.



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... did not follow an acceptance or procurement procedure.



- Clause 26 subcontracting supplemented by Works Information.
- Employer drives value for money through subcontracting procedures.
- Records = short list + tender evaluation and approval.
- Design proposals may be required prior to commencing work.



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... did not give an early warning.



- Clause 61.5 – PM notifies the Contractor when he instructs him to submit quotations.
- PM will assess extent of disallowed cost arising from lack of EWN.



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Correction of Defects



- Failure to comply with a constraint on how he is to provide the works.
- Works Information will detail particular constraints, e.g. hold points or sign off.
- Correction after Completion is disallowed regardless.
- Cost must be incurred, i.e. not assessed.
- Costs must be captured separately to allow it to be identified.



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Plant, Materials, resources not used to Provide the Works



- To Provide the Works – to complete the works in accordance with this Contract.
- Drive efficiency with materials and people.
- Question of reasonableness.



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When?



- Continuous process.
- Thorough, regular audit process.
- Agree to use rates and retrospectively change to cost to employ.
- Joint subcontractor inspections prior to final account.
- PM corrections to later payment certificates.
- Poor timing can adversely affect relationships!

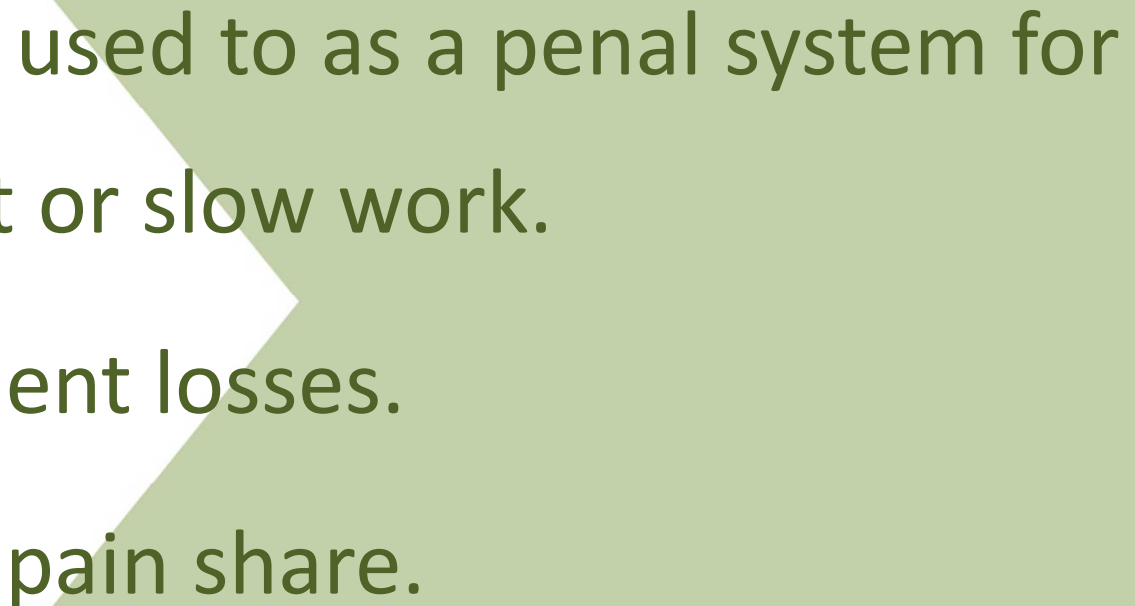


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Common misconceptions



- 
- Not to be used to as a penal system for inefficient or slow work.
 - Procurement losses.
 - Reducing pain share.



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3. COST VERIFICATION

Toby Holloway, Mytee Solutions Limited



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Introduction



- Why we need Cost Verification Audits.
- What Cost Verification gives to a project / program.
- Responsibilities.
- Tools.
- Accounts & records of Defined Cost.



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Why we need Cost Verification Audits



- Financial performance will be subject to intense scrutiny.
 - NAO, OGC, ISO 9001 Accreditation, Client Assurance Dept etc.
- Audits mitigate increased cost Risk
 - Identification of Disallowed Cost
 - Deterrent
- Majority of contracts will be let on a cost reimbursable basis

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What cost verification gives to a project / program



Protection – Upstream

- Implementing and managing processes that demonstrate to Clients and their representatives that we are complying with our obligations under the contract and in accordance with our own ISO9001 requirements.
- MAINTAINS / ENHANCES CREDIBILITY AND REPUTATION



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What cost verification gives to a project / program



Protection – Downstream

- It ensures the appointed Contractor is working in accordance with their own ISO9001 requirements.
- It provides certainty that we are only paying costs that are incurred in accordance with the main contract.
- It highlights failings in Contractors systems as well as identifying Disallowed (Not Defined) Costs.
- COMMERCIAL RISK MITIGATION TOOL – Deterrent to Contractor



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Responsibilities



- The Contractor is best-placed to contain cost.
 - The Contractor implements systems / processes in accordance with his own Quality assurance Requirements (ISO 9001).
 - The Contractor ensure costs incurred are in accordance with the contract and the Schedule of Cost Components.
 - Contract Administrator / QS should be fully aware of Contractors Cost management Systems.
 - Contract Administrator / QS to review Defined Costs using the accepted Cost Collection System on an on-going basis.
-
- Contractor Administrator identifies areas of risk and non-conformance and raises issues for corrective action.



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Cost Verification Function



- Auditing concentrates on areas of greatest risk and problems or high risk cost centres.
- Assists Project Teams to undertake in-depth reviews.
- Formalises upstream reporting procedures.
- Develops cross programme comparisons and lessons learned documents.



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Cost Verification Audits include:



- Review of financial and cost accounting procedures to ensure that they are in line with QA procedures – ISO9001.
- Review the contractors' accounting and cost accounting systems to ensure that they are adequate for the capture and reporting of contract assets (permanent and temporary) and expenditure.
- Confirmation that the actual costs included in monthly payment applications are in accordance with the schedule of cost components in the contract.
- Review the site controls and procedures in place to ensure full and adequate monitoring of the contractors' costs and charges.



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Accounts and Records of Actual Cost



- Cost Collection System.
- Trail to source documentation.
- Asset Registers.
- Purchase & Sales Ledger.
- Sub-cons Ledger.
- Plant Hire Register & on/off hire daybook.
- Time and Attendance reports.
- Access to salaries and payroll records.
- Staff Expenses & Petty Cash.

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Purchase Ledger



- Process Invoices / Credit Notes - from receipt to payment including matching to GRN's, plant hire returns, purchase orders, invoices held in query.
- Monitor spend against purchase orders and produce printed records for audit purposes.
- Retain all purchase order documentation and any changes thereto.
- Make timely payments to suppliers - description of payment methods to be utilised.
- The Contractor shall not make any 'on-account' payments without the prior approval of the Project Manager.
- Accruals - Accrual Print to be provided as backup to assessment.
- Examples:
 - Altered delivery address on supporting documentation.
 - Lost / damaged equipment written off under a new buy description.



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Capital Expenditure



- Monitor the effectiveness of purchase of equipment against hire.
- Authority levels required for purchase of assets.
- Manage capital purchases utilising the standard Asset Register Template provided, security tagging of assets, inclusion of residual values for all assets.
- Temporary asset disposal shall be managed in accordance with the Disposal of Temporary Asset procedure.

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Equipment Hire



- Monitor plant / equipment on and off hire dates
 - Site production personnel to be made accountable by use of detailed site requisition documentation inc. work areas, operations and hire durations of operated plant and equipment.
 - Control plant / equipment utilisation and build up of cost.
 - Demonstrate that selection was made on fair market rates.
 - Maintain and review a plant / equipment register.
 - Monitor, check and record deliveries and removal of plant/equipment
 - Provide plant / equipment and labour returns to the Project Manager on a weekly basis.
-
- Monitor the effectiveness of hire against purchase of plant / equipment – produce exception reports on long term hire dates.



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Materials



- Monitor, check and record deliveries and removal of materials, call off procedures.
- Control material wastages, reconciliation and management.
- Produce exception reports on bulk materials.



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Credits to Defined Costs (Sales Ledger)



- Process sales invoices.
- Record proceeds for temporary labour accommodation / scrap / assets, work for third parties etc.
- Examples:
 - scrap sold for cash.
 - temp assets sold for cash.



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Sub-Contract Ledger



- Process certificates and make timely payments to Sub-Contractors.
 - Monitor spend against sub-contract orders and produce printed records for audit purposes.
 - Retain all sub-contract order documentation and any changes thereto.
 - Retain all relevant documentation / backup to payments.
 - Monitor CIS certificates and maintain a CIS register.
 - Sub-Contract Final Accounts.
 - Effectively manage back to back type contracts with specific regard to Subcontracts with member Companies.
-
- Monitor internal Company charges and fee on fee issues.



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Labour (Direct and Indirect) 1



- Control the take on of labour by the completion of detailed labour requisitions outlining Trade requirement, work area / description and duration of operations together with originators name countersigned by senior site managers.
- The Project Manager shall review all approval for major labour intakes.
- Provide and monitor attendance for all People involved in Providing the Works through swipe cards / clock / timesheet cards which record hours worked.
- Operate a labour control system based on time-sheets authorised by site staff and coded according to the agreed code of accounts.

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Labour (Direct and Indirect) 2



- Provide an analysis of holiday accruals and actual holiday payments.
- Provide when requested by the Project Manager payroll build-ups and information to support pay entitlements for operatives.
- National Insurance Contribution build ups.
- Labour to be employed on direct status basis wherever possible in accordance with the current Project Managers Industrial Relation Procedures.
- Examples
 - No T & A control = Dead Men
 - Zero late starters/early finishers
 - Billed hours > clocked hours

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Monthly Paid Staff



- Engage staff in accordance with the Staff Resource Chart incorporated within the build up to the Prices.
- Provide and monitor attendance for all staff involved in Providing the Works through production of weekly / monthly timesheets.
- Provide an attendance register for salaried staff on a weekly basis highlighting periods of study, sickness, absenteeism, holidays, etc.
- Utilise timesheets to code staff cost according to the agreed code of accounts.
- Provide when requested by the Project Manager payroll build-ups and information to support pay entitlements for staff.
- Examples
 - over recovery of pension contributions (funding black holes)
 - redundancy accruals
 - over recovery of CITB contributions
 - agency staff – by pass resource chart



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Petty Cash



- Details of floats held, cashier, authorisation levels.
- Monitor petty cash expenditure.
- Examples:
 - charity donations without PM knowledge
 - works outings

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Expenses



- Monitor expenses expenditure.
- Review authorisation levels for expenses.
- Process and payment of expenses.
- Example:
 - Expenses claimed for “Partnering Events” on a weekly basis (the weekly drink paid by Contract Manager and passed on... plus fee!)



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QUESTIONS ARISING



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5. BREAKOUT EXERCISE – SUB-GROUP DISCUSSION



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Breakout Exercise : Sub-Group Discussion



(30 Minutes) Working in **Sub-groups**...

1. Consider EACH worked example provided.
2. Discuss the scenario described.
 - Consider an **answer** to the questions provided.
 - **Why?** Justify your answer.
 - Would any circumstances **change** your conclusion?
 - What other **observations** do you have?

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Worked Example 1: Contaminated Material



A Contractor brings material in to the site to use as fill and the material must meet strict criteria in the Works Information, demonstrated by a frequent testing regime. Some of the loads contain contaminants that make them non-compliant with the Works Information.

The Contractor begins to use the material without properly testing. The supervisor notices the contaminants and raises an NDW before Completion. The Contractor accepts that he should not be paid for the contaminated material (and has agreed this with his subcontractor / supplier).

However, the Contractor applies for the cost for removing all of the material already used (which by now has been covered with the next layer of substrate) and for the weekend work required to mitigate the delay.

What parts of the cost, if any, should be disallowed?

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Worked Example 2: Hire versus Buy?



The Contractor is required to provide lighting towers for the duration of the project.

The Works Information requires the Contractor to demonstrate value when considering hire versus purchase of equipment. The 'hire versus buy' scenario suggests that the lights are slightly cheaper to hire.

The Project Manager notifies that purchase would be more suitable but the contractor hires regardless. The project goes in to delay and the towers prove to be far more economical to purchase.

Is the cost over-run a Disallowed Cost?

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Worked Example 3A: Subcontract Procurement (Pt 1)



A Subcontractor not is competitively procured but the Contractor has already incurred substantial cost.

The PM disallows the full cost as the Contractor has not followed a procurement acceptance process required by the works information.

The Contractor assures the PM that some form of competitive tender had happened and that he knows the rates are about right for the work. He claims that he should be paid the full amount.

What should the PM certify for the Employer to pay?

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Worked Example 3B: Subcontract Procurement (Pt 2)



Further to 3A above, the PM certifies a payment in the first application but then disallows in the second application.

The Contractor argues that the payment must mean that the PM has accepted using the Sub-Contractor.

Had the Contractor been advised that there was a problem at the time of the first application he may have been able to reduce his cost exposure.

Does this change the conclusions reached at 3A, and if so, why?

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Worked Example 4: Performance Bond



As part of the tender requirements, the Contractor is required to provide a Performance Bond.

The winning Contractor states that the cost of the bond is included but he does not show it on the detailed activity schedule that he provides.

The Contractor applies for £20,000 for the cost of the bond.

Is the PM obliged to pay for the bond?

Or should it be disallowed?

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Worked Example 5: Contractor Records



The Contractor presents all of his records substantiating his equipment costs.

The Project Manager carries out an audit of the internal procurement department at the Contractor's head office and notes several credits appearing. These turn out to be corporate rebates for bulk buying and company wide supply chain agreements.

The Contractor argues that these are only achieved as company wide incentives and therefore benefits should flow to the company and not individual projects.

Should they be allocated to the project? And if so, how?



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Worked Example 6: Head Office Visiting Staff



The Contractor's application contains costs for head office staff and the Contractor is able to back up these with the relevant time attendance records for each person attending site meetings.

How does the Project Manager assess what is due?



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Worked Example 7: Equipment on Site



The Contractor applies for the costs of equipment on site (excavators, in this instance). The PM has been provided the time records and supplier hire charge invoices.

Following an equipment audit it is noted that the onsite records show the running time of the equipment to be significantly less than the hours being charged for.

Is the PM entitled to disallow the difference? Why?

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Worked Example 8: Cross-company Charges



Cross-company charge for plant (equipment) hire. Following on from Q7 the PM undertakes an audit of the internal equipment costs being charged to the project for Contractor owned equipment. During the audit it is noted that the charges include for administration costs.

The Contractor advises that this is to recover the cost of the staff at head office procuring and organising the equipment required.

The PM disallows the costs arguing that the cost of employment is recovered in the fees paid on costs of the equipment.

Is the PM correct with this approach?

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Worked Example 9: Working Area Overhead



The contract allows for a 10% Working Area Overhead (WAO) charge to be paid on Labour costs to include *'for the provision of hand tools not powered by compressed air.'*

Within the application the Contractor applies for the specific WAO fee and it is noted that there are also charges for electric drills and small generators used to power them.

The PM disallows the cost of both items and the Contractor argues that the generator is not a hand held tool.

How does the PM assess the amount due?



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Worked Example 10: Asset Disposal



The contract is nearing completion and the PM has noted throughout that the costs applied for in the Contractor's CCS is for items purchased throughout the project (Cameras, Projectors, Equipment, Fencing etc).

The PM undertakes an audit of the registers and notes that the items are no longer available as they have been scrapped, the audit team also note there has been no rebate of the scrap costs realised.

How does the PM assess what is due?



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6. BREAKOUT EXERCISE : KEY FINDINGS



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Breakout Exercise : Sub-Group Discussion



NOMINATE a

**Spokesperson to speak
for the Sub-Group.**



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7. CONCLUSIONS



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THANKS FOR YOUR PARTICIPATION.
