Growing Concern and Economic Uncertainty with a focus on Construction Auditing

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Agenda

• Outcomes of this presentation
• What is a construction audit?
• Construction statistics
• Why is it important to internal auditors?
• Variations of construction audits
• Types of construction contracts and associated risks to your organization
• What to look for during an audit
• High-risk areas and common issues
• Examples and case studies
Outcomes of this Presentation

• What a construction audit is and the variations of a construction audit
• Why a construction audit is important to your organization
• Determination if a construction project at your organization is a candidate for an audit
• The various scopes of a construction review
• Key high-risk areas to audit during a review
What is a Construction Audit?

First, we must know what we mean by construction:

- Not just new construction but also renovations, remodels, demolitions, etc.
- Across all industries worldwide (health care, entertainment, higher education, government)
- Includes schools, casinos, buildings, stadiums, highways/bridges, etc.
- Not just looking for cost recoveries or overbillings, but also provide process improvement recommendations for the project management team
What is a construction audit?

Construction audit

- Not just a cost recovery review but cost prevention
- Auditor involvement should start prior to contract execution
- Act as intermediary between owner and GC
- Assist with disputes and litigation
Construction Statistics

• During the 3rd quarter of 2012, U.S. economy has expanded for the 13th consecutive quarter (2% growth)
• However, non-residential construction has not
• 4.4% decline on annualized basis
• $851 billion in construction costs – September 2012

Source: Marcum Commercial Construction Index
There is hope...

- Billions of dollars in construction put on hold in 2012 could be put in motion in 2013
Why is it Important to Internal Auditors?

What does it mean to us and why are these audits necessary?

- “In some organizations, cost recoveries from contract audits exceed the entire annual budget for the internal audit department, . . .”
  
  From *Construction Contract Auditing* as published in INTERNAL AUDITOR, February, 1999, by James D. Cashell, CPA, MBA, PHD; George R. Aldhizer, III, CPA, PHD; and Rick Eichmann, CIA

- Typical recoveries are 1 to 3% of total project cost
Why is it Important to Internal Auditors?

What does it mean to us and why are these audits necessary?

- The risk - billions of dollars spent by organizations on capital expenditures each year
- Our job is to provide independent and objective assurance that company money is handled appropriately
- Lack of resources and sound processes/procedures by project management team to adequately safeguard assets
- Improve internal controls around the owner project management function
Why is it Important to Internal Auditors?

What does it mean to us and why are these audits necessary?

- Top management is concerned and exposed
- Projects are costly and subject to overcharges
- Identify opportunities for cost savings and/or cost recovery
- Provide independent verification of payments
- Delays can result in lost market opportunity and revenue
Why is it Important to Internal Auditors?

**Common rebuttal:** “We have worked with the same GC and no issues or cost overruns have occurred in the past.”

- Just because a project is on budget or was completed under budget does not mean all costs were appropriate.
- Was the original budget a sound figure?
  - Sound bidding and budget policies and procedures needed.
- Aggressive GC savings established
  - Incentive to come in under budget.
- Scope completed as planned
  - Scopes of work eliminated to maintain budget.
- Substitution of materials
  - Utilize materials of lesser value and quality to limit cost.
Why is it Important to Internal Auditors?

**Common rebuttal:** “GCs that work on our jobs have never been convicted of fraud.”

- Generally overcharges or unallowable costs are not due to fraudulent activity
- Regardless of contract – “This is how it has always been done.”
- Lack of resources by owner and/or GC
- Lack of communication between owner and GC/architect
- Excessive change orders/scope changes
- Mathematical errors
- Abundance of paperwork
Why is it Important to Internal Auditors?

However, some of these costs turn out to be fraudulent – Lend Lease (Bovis)
- Cheated clients out of millions of dollars in overbilling scheme
- Undercut competition to get a job, then padded the books with change orders – often with the client’s knowledge
- Submitted falsified invoices to clients for labor when contractors were on vacation or sick
- Occurred over a decade’s time!
- Agreed to pay $56 million to settle charges of overbilling clients
Variations of Construction Audit

- Contract review
- Cost segregation
- Job walks
- Limited scope/full scope
  - Only audit select COs or pay applications
  - Audit from bidding to project close out
- Based on contract type (GMP, lump sum, etc.)
Contract Types

What are the types of contracts and the associated risks:

- Lump sum
- Time and material
- Cost plus
- Guaranteed maximum price
Contract Types

Lump sum

- One price which includes fee, cost of work and general conditions
- Assigns majority of the risk to the contractor
- Potentially higher markup by GC to take care of unforeseen contingencies
- Elimination of scope or low quality materials to stay within budget
- Change orders should be scrutinized
Contract Types

Time and material

- Owner pays for actual cost of work (labor, material, equipment cost, etc.) plus a markup
- Markup is generally a set percentage
- No incentive for GC to reduce costs
- Low productivity by GC
- Owner must establish labor rates, material costs and equipment rates prior to contract
- Owner requires additional supervision
## Contract Types

### Cost plus

- GC is reimbursed for specified allowable costs plus a fixed fee
- No incentive by GC to reduce cost
- Owner assumes risk for cost overruns
- More supervision required by owner
- Low productivity by GC
Contract Types

Guaranteed maximum price

- GC guarantees the project will be built within a predetermined amount
- GC is reimbursed for actual cost plus a fixed fee
- Savings are generally shared with the GC
- GC may not use best personnel on job
- Must audit job cost ledger
What should be included in your Audit Approach?

• If possible, auditor involvement should occur before contract signing

• Contract language should be updated to reflect the type of project and contract
  - Identify contradictory language
  - Lack of specific provisions (insurance, audit clause, etc.)
  - Clarification on allowable and unallowable costs
  - Penalties in place for nonconformance with contract
What should be included in your Audit Approach?

• Getting started: Who are the players?
  - Owner’s project management team or 3rd party construction manager
  - General contractor and subcontractors
  - Architect

• Utilize a questionnaire to get a perspective
  - Who, what, when, where, how and why
What should be included in your Audit Approach?

• Process and procedure control review
  - Competitive bidding
  - Capital approvals/expenditures
  - Compliance w/policy and procedures
  - Payment applications
  - Change order process
  - Estimating and scheduling
High-Risk Areas and Common Issues

• Auditing internal procedures, bid processes, change orders and pay applications are not the beginning and the end.
• There are several key risk areas that lend themselves to unnecessary costs that effect your organization’s performance.

Of course this list is not the beginning or the end either...
High-Risk Areas and Common Issues

• Change orders
• General conditions (allowable vs. unallowable cost)
• Material costs
• Equipment rental costs
• Labor and labor burden
• Subcontractor payments
• Bid process
• Buyout of subcontractors
High-Risk Areas and Common Issues

Change orders

- High-risk
- Owner’s contract must include detail requirements for estimating/pricing and the ultimate billings of costs
- Strong procedures and processes must be in place
- Markup percentages vary by level of contractor
- Adequate support often not provided
- Review of labor rates, if not agreed upon in advance, is time consuming
High-Risk Areas and Common Issues

General conditions

- High-risk
- Owner’s contract must include detail requirements what is considered allowable and unallowable
- Too many supervisors on site
- Excessive entertainment and travel
- Sales tax on exempt projects
- Rebates or cash discounts not passed to owner
- Excessive relocation, moving, transportation and communication costs
High-Risk Areas and Common Issues

Material costs

- High-risk
- Owner’s contract and plans must include detail requirements as to what material is requested and to be used during the construction process
- Materials charged from another job
- Excessive order of materials
- Excessive material storage charges
- Credits not received for returned materials
High-Risk Areas and Common Issues

Equipment rental costs

- High-risk
- Owner’s contract and plans must include detail requirements as to what equipment is expected to be used on the job
- Contract should indicate what equipment is anticipated to be rented through the GC
- Contract needs to specify what is allowed
- Use industry benchmark data
- Charges in excess of total value
  - AED Green Book for example
High-Risk Areas and Common Issues

Labor and labor burden

- Labor burden percent used is often incorrect
- Labor burden often includes non-reimbursable items:
  - Bonuses
  - Parties
  - Education
- Unemployment tax still charged after maximum reached
- Ease on owner and auditors if rates, including labor burden, are agreed upon for all crafts before work starts
- If not, contracts must define what is allowable in labor burden build ups
High-Risk Areas and Common Issues

Subcontractor payments
- Back charges not passed through
- Markups calculated incorrectly
- Duplicate COs
- Errors in payment application
High-Risk Areas and Common Issues

Bid process

- Need sound internal policies, procedures and processes
- Adequate bid schedule
- General contractor/project managers competing for packages of work
- Design documents completed
High-Risk Areas and Common Issues

Buyout of subcontractors

- Critical for contracts with a guaranteed maximum price (GMP)
- Variances (under-runs) accrue to the owner
- Risks
  - Buyouts are not reviewed/managed by owner
  - The GC transfers the variance to its self-performed budgeted line items
Case Study #1

Background and business objective

- The project, a new retail facility completed for $9 million, was 100% complete when the client requested audit assistance.

- The construction agreement was for a guaranteed maximum price. The audit scope included analysis of the construction contract and an evaluation of the contractor's billing to determine compliance.

- The owner also requested recommendations for best practices and/or procedural improvements that could be incorporated into the owner's project management process.
Case Study #1

Approach and solution

- The first objective of the audit was to review documentation of costs incurred and paid for by the owner in completion of the project to determine if the requests for reimbursement were in alignment with the applicable contracts.

- The scope of the audit included all costs invoiced by the general contractor including subcontractor costs, in addition to direct costs paid for by the owner.

- The second objective of the audit was to obtain an understanding of the control environment surrounding this particular project to determine if any control deficiencies were noted.
Case Study #1

Outcomes and results achieved

- Potential overcharges totaling $250,000 (2.8% of the contract value) was identified due to inaccurate labor burden billing rates. The general contractor billed labor build ups (FUTA, SUTA, workers compensation, insurance, etc) at full regulatory rates rather than the actual rates incurred and to be billed per contract requirements. This was identified by viewing actual detailed labor records provided by the general contractor.

- Provided the owner with over 10 process and procedural improvements to easily identify and prevent these costs from being passed through during the course of projects going further.
Case Study #2

Background and business objective

- The project, a new outpatient facility completed for $42 million, was approximately 50% complete when the client requested audit assistance.

- The construction agreement was for a guaranteed maximum price.

- The audit scope included analysis of the construction contract and an evaluation of the contractor's billing, specifically equipment rental rates and general contractor markups, to determine compliance.

- Client PM identified what he thought excessive equipment rates on job cost report.
Case Study #2

Approach and solution

- The objective of the audit was to review documentation of costs incurred and paid for by the owner in completion of the project to determine if the requests for reimbursement were in alignment with the applicable contracts.

- Specifically, a full detailed review of equipment rental rates and markup percentages on change orders was performed.

- Approximately $8 million was added via change orders for the project. The scope of the audit included all costs invoiced by the general contractor including sub-contractor costs, in addition to direct costs paid for by the owner.
Case Study #2

Outcomes and results achieved

- Potential overcharges totaling $100,000 were identified due to:
  - General contractor owned rental equipment billed in excess of the fair market value
  - Overhead and profit were calculated by applying 5% overhead before applying 10% profit by general contractors and subcontractors resulting in a tiered profit margin
- These overcharges were identified by reviewing general contractor rental equipment charges applied to the job and comparing their fair value to the charges applied to the job.
- Approximately 90% of the tools/equipment charged to the job were billed in excess of the fair market value.
- The tiered markup was identified by recalculating markups applied by the general contractor and subcontractors on change orders.
Summary

• Recap
• Procurement of capital construction assets involves high-risk activities and complicated execution processes.
• Construction audits are not an expense – they are necessary for sound, effective cost management that reduces total project costs.
• Construction audits are an essential internal control process to maximize capital program effectiveness.
• Auditor involvement in the beginning provides a tone of oversight and often results in limited cost overruns or overcharges/billing errors.
Thank you!

Questions?

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