



# High Payback Construction Audit Tips

April 27, 2016

**MOSS ADAMS** LLP  
Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

# Presenter



## **Curtis Matthews, CPA, CCA, CPE, CGMA**

*Partner in Charge*

Curtis is the Partner In Charge of Moss Adams' Contract Compliance and Control Solutions Practice and brings over 30 years of relevant experience. He formerly directed Construction Risk Management Services for PricewaterhouseCoopers LLP and was responsible for the worldwide construction audits covering Intel's multi-billion-dollar projects.

Curtis has helped project owners negotiate favorable contract terms, implement strong project controls, monitor construction controls performance and ensure that construction project charges are compliant with contract requirements.

# About Moss Adams LLP

- National Audit and Consulting Firm
- Perform over 50 construction audits annually
  - Contract review
  - Cost and control audits
  - Change order and payment application review
  - Construction program performance audits
  - Federal contract compliance audits
  - Construction program policies and procedures
- Project and contract sizes range from \$10 million to over \$3.5 billion
- Multiple industry segments

# Objectives

After completing this session, participants will have an understanding of:

- How to achieve high payback from construction audits.
- Significant construction program risks and exposures that require strong controls over cost, schedule, scope and quality.
- Audit techniques and controls that will help uncover project overcharges and costly practices.

# Agenda

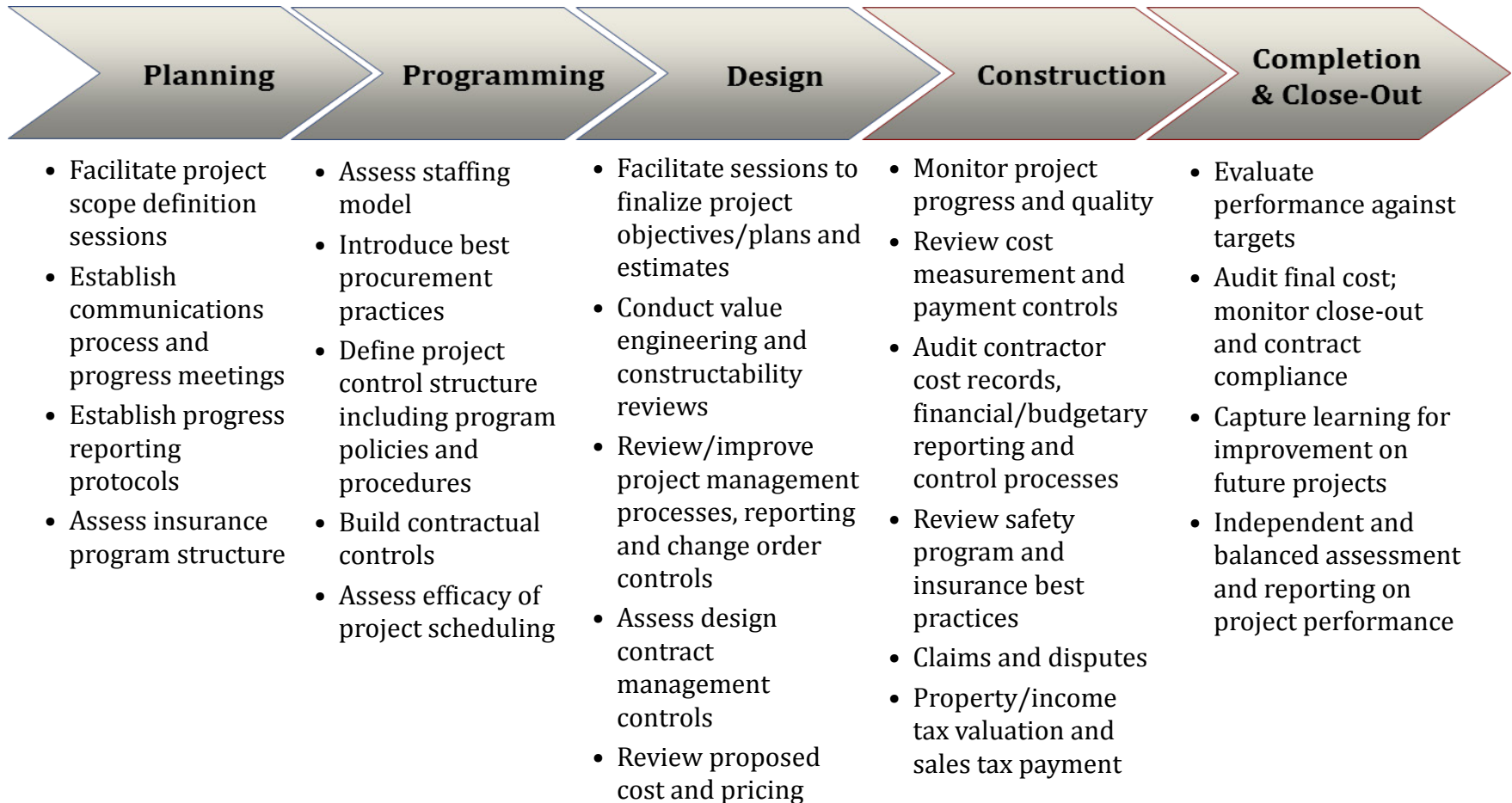
- Overview of Construction Program Processes
- Key Construction Control Focus Areas
- Best Practices
- Common Construction Project Exposures
- In-Depth Look at Construction Contract Controls
- Anticipated Construction Control Results
- Takeaways and Moving Forward

# Construction Program Process

- A construction program can be broken down into five major categories:
  - Planning
  - Programming
  - Design
  - Construction
  - Completion and Close-Out
- It's important to understand the tasks required throughout the construction program lifecycle to ensure that adequate staffing, controls and risk mitigation techniques are in place.



# Key Construction Control Focus Areas



# Best Practice Planning Tips



- Include the right people on your program planning.
- Identify the organization's construction needs:
  - This includes master planning for organizations with significant capital project funding.
- Establish internal and external requirements:
  - Internal – communication and reporting protocols and construction oversight requirements.
  - External – staffing needs (e.g., in-house, third-party designer, contractor, consultants, etc.) and funding source requirements, to name a few.
- Conduct meetings with core team/planning committee to define project scope and objectives.
- Create a proposed construction audit schedule.



# Programming Best Practice Tips

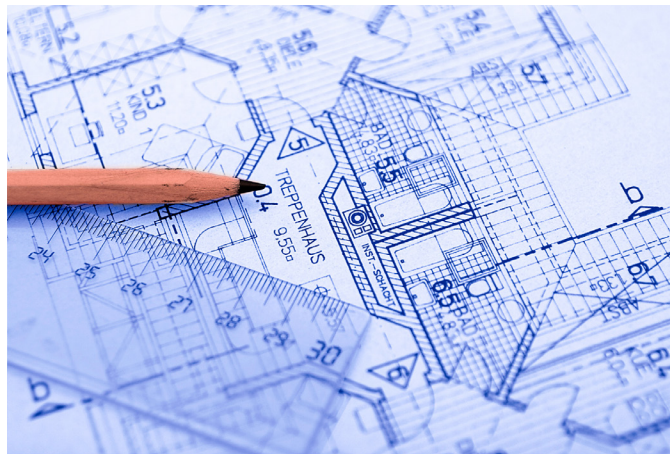
- Determine organization staffing needs:
  - Evaluate the need for external program management depending upon construction program size, complexity, estimated time commitment and cost.
- Clearly define approval and authorization levels.
- Modify boilerplate contract language to incorporate strong controls.

# Programming Best Practices (cont.)

- Ensure that policies and procedures are well-defined and up to date:
  - Bid and procurement policies should define the competitive bid process to ensure fair pricing, understanding of scope and fraud prevention.
  - Bid advertising, administration, and evaluation/RFP process requirements should be reviewed to ensure that staff involved are aware of best procurement practices.
- Create preliminary program and project schedules.

# Design Best Practices

- Conduct competitive procurement process for Architect/Engineer services:
  - Review and evaluate proposed cost.
- Assess design contract management controls.
- Finalize project scope and estimate project budget by conducting value engineering and constructability reviews.
- Utilize architect/engineer in contractor selection process.



# Construction Best Practice Tips

During the construction phase, it is important to:

- Verify accuracy/allowability of cost with payment application supporting documentation and project cost reports.
- Evaluate change orders for approved change order requests including allowable and supported costs.
- Assess labor and related burden charges.
- Ensure compliance with contract terms.
- Ensure that the Contractor's policies and procedures align with the Owner's.
- Remember that your contract is a significant defense against common construction project exposures.

# Common Construction Project Exposures

- Unfavorable contract terms and controls
- Noncompetitive bidding practices
- Inaccurate project financial records and reports
- Insufficient documentation to support amounts charged
- Labor hours charged do not match hours worked
- Inaccurate labor burden rates
- Unauthorized employees/positions charged
- Labor rate charges not in compliance with contract rates
- Unrecovered overhead charges
- Scope creep and excessive change orders
- Material cost billings do not match materials used on the project/quality issues
- Available discounts not taken
- Substitution of materials that do not match specifications
- Project funding not aligned with project plans
- Charges for contractor or subcontractor damages
- Credits not claimed
- Insufficient cost and billing controls
- Claims and disputes

# Construction – Contract Controls

- Fees
- General conditions costs
- Insurance and bonds
- Labor and related burden
- Subcontracts
- Rental equipment
- Change orders
- Self-performed work
- Right-to-audit language



# Construction – Contract Controls: Fees

- Fee percentage to be applied to cost of work should be competitively benchmarked
- Fees charged should match contract value and contractor risk factors
- Exclude certain cost items from the fee calculation:
  - Insurance
  - Performance bonds
  - Permits
  - Self-performed work

# Construction – Contract Controls: Fees (cont.)

**When fee percentages are used, the contract language should define exactly what comprises “cost of work” for fee percentage application:**

*“The following elements of the cost of work, although reimbursable as part of the cost of work, shall be excluded from the cost of work for the contractor’s fee calculation....”*

**Federal contracts do not permit the application fee as a percentage of cost. Fixed and incentive fees are the most common.**



# Construction – Contract Controls: General Conditions Costs

- Contract should contain specific language for costs to be reimbursed (allowable and unallowable costs).
- Costs to look out for:
  - Communications (Internet and cell phone).
  - Computers and software.
  - Meals and entertainment.
  - Relocation.
  - Safety incentives.
  - Purchase card expenditures.
- You, as the owner, should determine and communicate acceptable limits. Do not be swayed by the phrase “industry standard.”

# Construction – Contract Controls: Insurance and Bonds

- Insurance calculations should be based on the direct cost of work.
- There are no “silver bullets” when picking among the various protections:
  - General Liability Insurance (GLI).
  - Subguard – replaces performance bonds.
  - Builders risk and performance bonds.
  - Owner-controlled insurance program.
  - Contractor-controlled insurance program.



# Construction – Contract Controls: Insurance and Bonds (cont.)

- If the project includes an Owner Controlled Insurance Program (OCIP) or Contractor Controlled Insurance Program (CCIP):
  - Ensure subcontractors are aware of this and include insurance costs are not included in their pricing.
- GLI, Subguard and insurance program rates should be stipulated in the contract at market rates.
- Cost charging compliance should be verified with accurate application of safety experience factors is core to detecting overcharges.
- Comprehensive and ongoing training on safety procedures and claims compliance will help protect you.
- Policies and tools should be in place to ensure safety precautions are in place.
- Ensure policies and compliance documentation is up to date to protect your organization.

# Construction – Contract Controls: Labor and Related Burden

- Two methods:
  - Actual cost.
  - Stipulated rates.
- Two types:
  - Salaried/project management.
  - Hourly/craft labor.
- Actual cost is preferred; stipulated maximum rates are a good practical method.
- Stipulated rates can provide a profit center to the contractor.



# Construction – Contract Controls: Labor and Related Burden (cont.)

- If you allow stipulated rates, ensure that your contract spells out what is included in the burdened rate (actual cost, payroll taxes, insurance, etc.) and have allowable rates specified.
- Exempt (salaried/project management) labor should not be charged to the project for more than 40 hours per week or the basis from which the rate was derived.
- Ensure labor burden rates reflect a decrease for overtime and double time.
  - Fixed elements of cost in burden rates are generally reimbursed after the first 40 hours.

# Construction – Contract Controls: Subcontracts

- Subcontracts typically comprise 70 to 80 percent of the total contract value.
- Your project manager should be involved with the general contractor's (GC) bidding process to ensure:
  - Subcontractor qualification process is in place.
  - Project scopes are clear to bidders.
  - Competition is applied properly.
  - Bids are accepted, reviewed and appropriately awarded.
  - Approach to selection is unbiased and cost effective to the owner.

# Construction – Contract Controls: Subcontracts (cont.)

- Subcontract types:
  - Most subcontracts are lump sum.
  - Larger subcontracts (i.e., mechanical and electrical) can be Guaranteed Maximum Price (GMP).
  - For GMP subcontracts, the general contractor (GC) needs to implement controls to ensure that the subcontract includes flow-down terms and conditions from the GC prime contract.



# Construction – Contract Controls: Rental Equipment

- Provides a contractor profit center.
- Two key risk areas – monthly rate and total payments.
  - Conduct buy or rent decisions for all major equipment items.
  - Monthly rental rates should be stipulated to not exceed a percentage of published rental rates or local prevailing rates.
  - Cap total rental payments at a stipulated percentage of fair market value (FMV), document the cap and track payments against this cap.
- Owner approval (typically your project manager) should be required for deployment of rental equipment to the construction site.





# Construction – Contract Controls: Rental Equipment (cont.)

- If maintenance is included, define allowable maintenance and limit cost charges.
- Make sure you fully understand what technology equipment and software are necessary for the project.
  - Costs that are not caused by your project are not allowable direct charges.
  - You are not required to pay for costs of company-wide software and systems utilized across contractor operations.
  - Corporate information technology allocations are generally not allowable and are often not supported.
- Costs should be fully supported and caused by the project.

# Construction – Contract Controls: Change Orders

- Typical contract change progression:
  1. Request for Information (RFI).
  2. Change Order Request (COR).
  3. Change Order.
- Supporting cost documentation required – increases and decreases to the contract total.
- Lump sum change orders are of greater risk than GMP changes.
- Understanding cause and scope of the change is critical.
- Must be approved by Owner, Architect/Engineer (AE) and GC.
- Do not pay for subcontractor/GC/AE errors and/or damage.
- Ensure cost charges are supported (quantities and cost charges), including credits for deductive work.

# Construction – Contract Controls: Self-Performed Work (SPW)

- Work that is typically subcontracted is performed by the general contractor.
- Often these charges are cost reimbursable and must be supported with cost records.
- SPW should be excluded from the contract fee calculation and have a stipulated SPW markup.
- Proposed SPW costs should be validated through competitive bidding process or independent evaluation of proposed cost.
- If lump sum work is also performed by the same contractor, look for costs shifted from lump sum work to cost reimbursable SPW.
- Amount of awarded SPW should be limited or capped to reduce exposure.

# Construction – Contract Controls: Right-to-Audit Clause

- Ensure you have a good right-to-audit clause in your contract.
- Audit rights should be sufficiently clear to enable efficient and complete auditing of charges.
- There should be no audit scope limit.
- Require all supporting documents be available upon request.
- Conduct a risk assessment to determine greatest areas of exposure and conduct audits throughout the construction process.



# Audit Timing is Key!

- Cost compliance audits:
  - Initial – Generally conducted after about three payment applications are submitted to verify controls compliance.
  - Midpoint – To verify control recommendations have been implemented and to true up costs to date.
  - Close-out – Prior to final payment to verify cost compliance.
- Other audit timing approaches:
  - Quarterly – Larger multi-year projects require this approach due to risk in the large amounts expended as the project progresses.
  - Ongoing approach – Replacing internal staffing with audit review of payment applications to achieve efficient resourcing and benefit from auditor capabilities.
- Contracts and change orders:
  - Before contract and change order approvals occur.

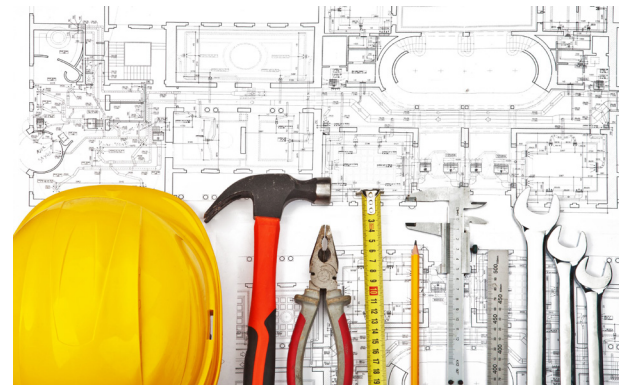
# Completion and Close-Out

- Evaluate performance against targets for (1) cost, (2) schedule and (3) quality.
- Audit final cost prior to payment to help ensure that all project dollars are compliant.
- Review final documents to ensure receipt of contractually agreed upon deliverables, such as:
  - Completed and final punchlist.
  - Final, unconditional lien releases.
  - Redlined as-built drawings.
  - Manuals, warranties and guarantees.
- Document successful practices and future improvement opportunities in policies and procedures.

# Anticipated Construction Control Results

## **Implementation of effective construction controls results in:**

- Project economy, efficiency and cost control.
- Prevention of problems and early detection of risks and overcharges.
- Compliance with contract requirements and existing policies and procedures.
- Tighter construction program controls.
- Reduction in errors, excessive cost and overcharges.
- Improved communication.
- Protection of stakeholder funds.



# Takeaways and Moving Forward

1. Have well-defined, clear terms and necessary contract protections.
2. Establish policies, procedures and controls prior to project commencement.
3. Maintain a construction audit schedule and conduct construction audits early and often.
4. For new projects, utilize audit support to negotiate favorable pricing and contract controls.
5. For construction projects in process, conduct a project risk assessment to determine which “common construction project exposures” are most relevant to your organization.
6. Build in effective controls design and monitoring controls to prevent the kinds of cost exposures discussed today.
7. Assess the staffing and controls you have in place to address construction risks.
8. Validate your controls and audit to ensure adequate coverage in each major construction project phase from planning through close-out.

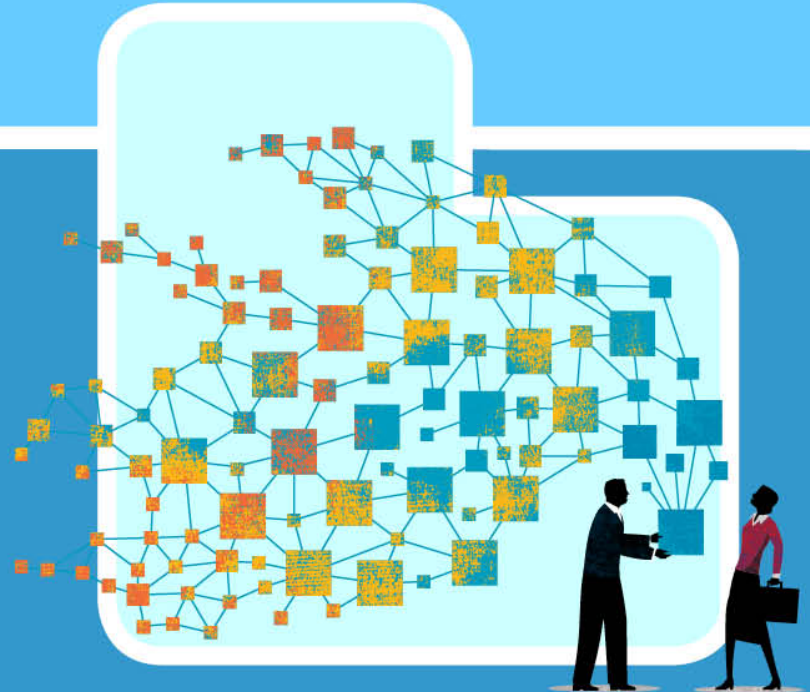


# Questions?



*Thank you for attending!*

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