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Construction Audits

Construction audits on the job help owners trim project costs

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With annual commercial construction permits in Houston reaching approximately \$7.5 billion, project owners should ask themselves several questions:

- Does the construction contract include the right protection for the project owner?
- What is the best way to ensure the contractor and vendors are fully complying with the contract?
- Is the project likely to finish on time and within budget?
- What kind of help is available to answer these questions and help manage the cost of the overall construction project?

Getting serious

Recent business failures and new regulations have made companies, nonprofit entities and government agencies get serious about internal audit and expenditure control. In addition, a tight economy has triggered a renewed interest in improved purchasing and expenditures processes and in looking for potential cost recoveries through contract, vendor, joint venture, construction and general accounts payable expenditure audits.

Construction projects are among the largest and most complex financial expenditures undertaken by many entities -- commercial businesses as well as nonprofit schools, churches, health care providers and government agencies. Contracts for new constructions, plant or building additions, major capital equipment overhauls and demolitions are complicated and include arrangements such as guaranteed maximum price, fixed and unit price, time and materials and cost-plus.

Most parties to construction contracts do not experience large construction projects every day, so it is unlikely they will have the appropriate internal expertise to negotiate and manage these contracts. On the other hand, this expertise is a core competency of the contractor being engaged, and the contractor will

have a dedicated staff focused on maximizing contract terms and profit. As a result, many owners end up with ineffective expenditure controls for these projects and place too much reliance on their contractor.

Construction Auditing

Construction auditors are available through consulting firms to work with project owners and level the playing field. They can advise the project owner through the life cycle of the construction project as well as audit transaction documentation for compliance with the terms of the contract.

Construction auditors are able to:

- Help negotiate an owner-favorable contract.
- Design and improve expenditure processes and controls.
- Ensure the accuracy and proper documentation of monthly applications for payment.
- Ensure full value is received through monthly monitoring and on-site inspections.
- Reduce overall project costs.

Many businesses succeed in achieving major savings with the help of construction auditors. For example:

- A major airline was managing a \$160 million airport expansion project scheduled over a two-year period. Construction auditors identified \$2 million paid out of airline funds rather than bonds, \$280,000 of change order overcharges, and \$240,000 in quantity variance.
- An office building construction project with projected costs of \$39 million was experiencing major cost and schedule overruns. Construction auditors identified recoveries for the owner totaling \$637,000.
- A large manufacturing company was constructing a steel processing facility with costs exceeding \$150 million.

The project included not only the construction of the building, but rehabilitation, purchase and installation of machinery and equipment. Construction auditors were involved with contract negotiation, establishing expenditure process controls, and monthly site visits to review charges and conduct tests of equipment usage. The totals of costs avoided and recovered were significant.

Cost Benefit Analysis

Good construction auditors will cost a project owner in the range of \$150 to \$200 per hour. While these are usually not full-time resources, the total expenditure can still be significant over the life of the construction project. In almost all cases, construction auditors will at least pay for themselves through cost recoveries. In fact, a general rule of thumb is that recoveries usually total eight to 10 times the amount spent on construction auditors.

Typically, construction auditors are able to recover expenditures totaling 1 percent to 2 percent of the total project. Based on the estimated annual construction expenditures in Houston, this is a potential annual cost recovery of \$75 million to \$150 million.

Several considerations are the top drivers of potential cost recoveries:

- Bigger contracts have more room for bigger recoveries.
- Time and materials contracts are subject to more billing errors.
- Contracts with a large number of change orders or a large number of subcontractors also are more likely to have billing issues.

Given the current trend toward improved control procedures and expense reduction, the fact that contractors have full-time construction cost experts, and the significant potential for cost recovery savings, project owners should carefully consider the need for construction auditing assistance.

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