

[FindArticles](#) > [Internal Auditor](#) > [Feb, 2000](#) > [Article](#) > Print friendly

10 Strategies for More Effective Construction Audits

Mark Conrad Ledman

Auditing contract payments is only the tip of the iceberg. Ten comprehensive recommendations may guide you toward more value-added construction audits.

NEW BUILDINGS AND RENOVATIONS typically represent the largest expenditures that organizations incur. While most audit shops regularly analyze contracts for payment issues, far broader reviews are needed. Auditing outside the standard contract issues can be vital in helping to reduce the financial and legal vulnerabilities associated with the construction process.

Each organization is unique, and your audit must obviously be based on your assessment of internal controls and the limitations of your audit scope. However, issues such as economic justification, regulatory requirements, construction policies, bid and performance bonds, insurance, project meetings, release of lien, project accounting, and controls over contractor selection should also be part of the audit package. These areas are targeted by 10 guidelines that can help auditors to reduce costs and minimize risks to their organizations.

1. ASSESS THE ECONOMIC JUSTIFICATION OF THE PROJECT

Incredibly, many construction projects are initiated without even the most basic cost-benefit analysis or feasibility study. Documented evidence justifying the project should always be submitted, even though proceeding with a project that will not result in an increase in revenue or financial position can be acceptable in some instances. Sometimes projects are undertaken to maintain market share in a competitive industry or to provide a service or product line that will complement another.

While senior management may have legitimate reasons for approving projects that do not improve the bottom line, many such projects are nonetheless the simple result of poor strategic planning and oversight. Auditors should determine whether the project is economically justified, approved at a high level, and based on sound assumptions.

2. RESEARCH REGULATORY REQUIREMENTS

Thorough reviews of the federal, state, and local regulatory requirements that pertain to your industry are essential. In health care, for example, most states require a certificate of need (CON) if the project does not meet specific exemptions. Some states mandate that a request for exemption of CON be obtained from the state. The auditor should select a sample of projects and confirm that CONs and any exemption certificates were properly obtained.

Similar regulations govern most other fields. Auditors must identify any regulatory requirements and review for compliance to reduce litigation exposure.

3. MINIMIZE THE RISKS ASSOCIATED WITH CONSTRUCTION ADMINISTRATION

Internal controls, compliance with policies and procedures, and the level of reliance on construction industry practices are all key audit factors. Internal controls are an invaluable aid to the efficient management of construction activities. Formal written policies and procedures provide the framework for employees to carry out their duties and establish accountability for their actions. Information regarding industry practices helps to establish benchmarks in a number of areas.

Auditors can help to reduce exposures by verifying that the following control issues are adequately addressed:

- * Review and approval process, including project initiation, budgeting, and changes.
- * Management oversight, risk management, and legal involvement.
- * Project documentation and reporting process.
- * Conflicts of interest, including issues related to fraud, acceptance of gifts, and indirect gifts.
- * Construction administration process, including a right-to-audit clause, change orders, substitutions, project overruns, and lien waivers.
- * Bid and award process, including project size; contractor solicitation, reference, and selection; and

controls over bid opening.

* Project completion and close-out. Standard contracts, such as those distributed by the American Institute of Architects (AIA), offer excellent models in terms of protecting the organization. You may want to have your legal counsel adapt the AIA documents for your organization's specific needs.

4. DON'T OVERLOOK BID BOND CONCERNS

A bid bond guarantees that the contractor is insurable and can obtain a performance bond, which is procured after the bid is awarded. A contractor who does not have the financial strength to secure a bid bond will be unable to obtain a performance bond. Auditors may want to raise the following questions regarding bid bonds:

* Are the appropriate parties, such as legal, risk management, and finance, periodically consulted regarding bid bonding limits?

* If a bid bond is not obtained, does the organization request financial information prior to awarding the bid?

* Does formal written policy mandate a bid bond when a performance bond is required?

The AIA contract documents provide appropriate contract language regarding bid bonds. Auditors can use these guidelines as a reference during their review of this process.

5. ENSURE THAT PERFORMANCE BONDS FULLY PROTECT THE ORGANIZATION

A performance bond covers your organization in the event that a contractor fails to perform in accordance with a contract. The insurance company will reimburse the organization for the unfulfilled contract amount. If the contractor continues to take on larger and larger projects, for example, the construction company may become overextended and may even enter bankruptcy. Proceeds received from the performance bond would then be available to the owner to finish the project.

Policies concerning performance bonding should be based on management's acceptance of risk. Typical policies require a performance bond for contracts exceeding an established dollar amount. Your audit should include a review of the performance bonds to ensure they are for the correct dollar amounts and

dated prior to the start of the contractor's work.

In reviewing contracts and contractor payments, you should consider the performance bond implications. The internal control can be circumvented by splitting the projects into many components, so that they fall under the organization's established performance bonding requirements or contract maximums. Circumvention can also be achieved by omitting a formal request for proposal (REP) and competitive bidding process. Finally, internal controls can be compromised when senior management or risk management is not periodically consulted regarding performance bonding coverage limits.

6. REVIEW COI COVERAGES AND RELATED DETAILS

A certificate of insurance (COI) demonstrates that a contractor has obtained liability insurance, generally for a specific time period. The COI provides some measure of protection to the organization in the event that an accident or damage occurs as a result of actions by a contractor's employee.

Your organization should have a formal written policy concerning the requirement of a COI, as well as a file of COIs for every contractor. The COIs should be obtained before the contractors are on site performing work and should be retained for a specified period of time after project completion. A sample of the COIs should be selected and reviewed for compliance with minimum coverages contained in the bid or contract documents.

To identify other business risks, auditors should verify that the certificate period is current. Contractors can often be on the job site long after the insured period has expired or the certificate has become outdated, especially since delays and scope changes may extend the duration of the project. Some COIs may omit dates entirely. Closely review all coverages for compliance with your organizational requirements, including procedures to confirm that:

- * General liability coverage limits are appropriate.
- * Workers' compensation coverage limits are appropriate or at least meet statutory requirements.
- * Other required coverage, like automobile or statutory, is appropriate.
- * The comments and exclusions section is appropriate.

- * Your organization is named as the certificate holder.

- * The certificate is signed by the insurance company.

- * Your organization is listed as an additional insured under the "remarks section" of the COI. Being listed as an additional insured gives the organization added protection against an independent third party should someone be injured or property be damaged as a result of the contractor's operation on your organization's premises.

If your organization is only listed as the certificate holder, you are simply being given documentation of the contractor's coverage, which affords no protection for you. Your organization's insurer would be required to satisfy the claim, which would have the long-term effect of an increase in your loss ratio. Consult your insurance agent to determine whether this language could reduce risk for you.

- * The insurance coverage minimums or limits stated in your bid and contract documents are reasonable. Also determine when these documents were last updated. Your risk management department, senior management, insurance agent, and legal counsel should periodically evaluate the insurance coverage requirements.

- * All organizational areas where contracted work can occur are identified. Even if your organization has a centralized department that coordinates all construction activities, exceptions can occur in areas where unique expertise has been developed, such as information services or research and development. These units may not fall under the auspices of the centralized planning and development department.

Beware of construction projects lie outside the formal arena. When these projects are identified, they should be reviewed with special scrutiny because many internal controls may be circumvented.

7. MONITOR OR ATTEND RELEVANT MEETINGS

In most organizations, several different groups hold meetings related to construction projects, and many of them can provide valuable information to an auditor. Top-level executive discussions are often referred to as the "building committee" meetings. Another typical meeting is attended by the construction manager, project manager, and members of the different construction companies or trades participating in the project. This meeting is sometimes referred to as the "construction" or "job site" meeting, or it may be

defined by the project's title. Some organizations also hold a separate safety and security meeting, which includes some of the same participants as the construction meeting.

Problems or significant issues can often be spotted in the minutes of the meetings. For example, you may detect:

- * Contractor damage or errors that should be "back charged."
- * Changes in labor or materials which may indicate that a credit change order should have been issued.
- * Unforeseen expenses incurred or a project expected to overrun, especially when additional internal or regulatory approvals may have been required.
- * Safety issues or concerns, including checks to see that risk management or the appropriate department has been made aware of them.
- * Documentation regarding overtime and whether or not it was authorized.
- * Issues that warrant the attention of a higher level of management.
- * Inspections not passed or permits not obtained on time.
- * Ongoing, unresolved issues. Except for those gatherings that involve senior executives or board members, internal auditors should try to obtain invitations to as many relevant meetings as possible. Risk areas and audit strategies will likely be indicated. Direct observations can reveal much more than minutes, which may be filtered by the construction manager. Additionally, some safety issues may be prevalent, and the risk management or legal departments may have discouraged documentation of certain issues for legal purposes. You should determine how these issues are communicated and whether or not they are proactively resolved.

8. EXAMINE ISSUES RELATED TO THE RELEASE OF LIEN

It's construction industry practice to obtain a "release of lien" from the contractor before final payment is made. This document protects the organization if a subcontractor or materials supplier sues the primary contractor for nonpayment.

Your organization should have a defined policy concerning these releases. Many organizations establish guidelines that involve contract amounts, and they further reduce risk by obtaining partial releases. You'll want to verify that the final, executed release of lien is obtained before final payment is made. In addition, you should confirm that any amendments a contractor may have written on the release before signing it are appropriate, and that the guidelines established for partial release of lien are followed.

9. LOOK FOR ACCOUNTING IRREGULARITIES -- BOTH INTENTIONAL AND UNINTENTIONAL

As part of your detail testing, find out how projects are being coded in the general ledger account and determine whether the project should remain active. Coding to the wrong project, whether intentional or unintentional, can result in management decisions that are based on inaccurate data. Intentional coding to another construction project may be contrived to avoid scrutiny of a project-cost overrun and requisite approval and reporting. Both errors and omissions lead to misstatements concerning financial reporting and cause problems such as the following:

- * When a construction project is complete, a "useful life" is assigned based on guidelines for "useful lives of assets." Inaccurately classifying an asset could accelerate or decelerate depreciation expense and impact income reported in a given accounting period.
- * If projects are not closed out on time, financial statements may be misleading because depreciation expense is understated, falsely increasing profitability on the income statement.
- * Depreciation accruals may be adversely impacted.
- * Construction loan interest may not be properly presented and capitalized in accordance with generally accepted accounting principles (GAAP).
- * Cost accounting systems may be adversely impacted.

You should obtain construction project management reports and review contracted amounts, paid-to-date, and cost-to-complete to determine whether all liabilities have been properly recorded. It is also important to review payment for stored materials. A payment may have been made for materials that have not been received.

10. GUARD AGAINST BIO-RELATED INTERNAL CONTROL BREAKDOWNS

Every organization wants to procure goods and services at the lowest possible costs while maintaining acceptable levels of quality. In many cases, this drive creates such a sense of urgency that the completion of a project can take precedence over internal controls.

Competitive bidding helps to ensure a wider choice of suppliers and products and higher quality goods and services at lower prices. A request for proposal, purchase order, or contract document provides adequate authorization for the purchase, clarifies the expectation of goods and services, and outlines the proper segregation of duties. This documentation also guarantees that a purchase decision analysis is made and documented for future reference. The following audit procedures may be relevant:

* Evaluate the bid tabulation and vendor solicitation and selection processes.

1 Confirm that documentation specifying the terms and conditions of work performed is adequate, so that proper evaluation and approval can be obtained. For example, descriptions should be provided for work to be performed, including labor rate, hours, and materials; goods purchased; delivery requirements; payment of vendor invoice or discount; and freight terms and charges.

2 Ascertain how vendors become approved vendors. Know the minimum qualifications for bidding on work in your organization.

* Confirm that purchases are made from vendors whose interests are not in conflict with persons in your organization. At a minimum, senior management should be notified of potential and existing conflicts of interest.

* Observe a pre-bid meeting to see how it is conducted and note any issues that may circumvent the free flow of information.

* Consider a bid package that requires the contractor to attach a formal written safety program--and make the safety program a condition of awarding the bid. Contractors with poor safety records may take unnecessary risks or allow poor work habits that could adversely affect project schedules, impact other contractors, or increase risk of litigation.

* Obtain trade labor rate data. The base labor rates for 46 major construction trades in major u.s. cities are

available in the book, Means Labor Rates for the Construction Industry-which may be ordered online at <http://nt.receptive.com/rsmeans/bookstore>; choose "All Cost Data Books." Compare the labor rates from the contractors used at your organization to determine whether they are comparable to those listed.

* Investigate the solicitation of minority contractors. If your organization receives certain state or federal funding, minority bidding practices may be a regulatory requirement.

* Determine whether contractors performing work are registered with the state.

* Since the construction industry is cyclical and somewhat volatile, it's important to confirm that the contractor's financial viability was investigated before the construction bid award.

If you are employed by a not-for-profit organization (NFP), it may be possible to save on sales tax if construction materials can be delivered from the wholesaler or supplier directly to your location. Some contractors deliver the "bricks and mortar" to the construction site because of their own storage limitations, but the NFPs don't always take advantage of the potential sales tax savings. Any NFP should consider this opportunity up front and incorporate it into the bidding process where feasible. Cost of storage and security of materials should be evaluated as part of this decision.

UPPING THE ANTE

Changes in the work force and escalating economic growth in many areas are both key factors in exposures associated with new construction and renovation. As a result of restructuring and transfer of responsibilities, inexperienced personnel may be taking on tasks related to vendor selection, negotiation techniques, and purchasing. At the same time, the number of construction projects is increasing. Construction expenditures in the health care industry, for example, have risen 29 percent over the last year, according to Modern Healthcare magazine.

Adherence to a sound system of internal control has never been more important, and the risks may never have been greater. Internal auditors should not be content to look only at contract payments. They should assess construction-related exposures and implications from a broad perspective and act to protect and strengthen their organizations.

MARK CONRAD LEDMAN, CPA, MPA, is Manager, Internal Audit at Lakeland Regional Medical

Center in Lakeland, Florida. He is also Editor of *New Perspectives on Healthcare Auditing*, a quarterly journal for health care auditors and other professionals.

COPYRIGHT 2000 Institute of Internal Auditors, Inc.

COPYRIGHT 2002 Gale Group