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Building a foundation for a contract audit

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For major engineering and construction (E&C) projects, the contract audit can be an effective tool to do more with less and help eliminate wasteful spending and cost overruns. Construction owners, real estate developers, joint venture partners, and project stakeholders are incorporating contract audits into their standard operating procedures for monitoring and controlling building projects. This paper provides guidance for contractors on how to prepare for a contract audit, offers insight into how auditors approach contract audits, and recommends procedures for managing the audit process.

Why prepare before you have to?

Contract audits are not going away. Every year, corporate and government audit teams review hundreds of billions of dollars in spending, identify billions of dollars of potential audit issues, and recover millions of dollars in contract overpayments on individual projects.[1] Frequent news reports about cost overruns and delays on large construction projects fuel concerns for more accountability and increased scrutiny of contractor spending.

As pressures mount for E&C companies to win and deliver successful results on construction contracts, demonstrating sound project management and cost control practices has become increasingly important. For example, many E&C companies are implementing more robust monitoring processes to periodically inspect contractor and subcontractor cost reporting systems, purchasing documents, payroll records, employee timesheets, bank records, invoices, canceled checks, transaction records, and operations logs.

E&C companies may also proactively perform contract compliance self-assessments, which can be very effective in preparing for owner contract audits and can benefit an E&C company's contracts overall. Demonstrated compliance with client contract provisions encourages strong, mutually beneficial owner-contractor relationships. A track record of reliability can help position an E&C company to compete for lucrative contracts. Effective controls help them strengthen their competitive posture, avoid mistakes, and deliver successful projects.

Auditing of construction contracts is no longer confined to unique project or contract circumstances, or initiated primarily by state, local, or federal governments or cost-conscious owners. Such audits are becoming standard protocol on many major construction projects. KPMG has the experience to help contractors identify the proper strategies and controls needed to succeed in working with a wide variety of government, corporate, nonprofit, and private entities through our global network of member firms.

Tailoring contract audits

Construction contract audits vary by circumstance (project time line or operational need), type of client (government or private), and contract type (fixed-price or cost-based). Audit emphasis varies accordingly and the approach must be tailored to the entity. They may occur at various stages of a construction project. Common E&C contract audits include:

- Contract closeout audits—typically completed before final payment is made.
- Two-phase audits—the first phase typically is scheduled near the beginning (such as at 20 percent project completion) and the second before final payment is made.
- Monthly payment audits—these keep a close watch on contract cash outflows and help to resolve potential problems before they lead to delays and cost overruns.
- Other—quarterly, semiannual, or annual audits are common for long-term projects.

[1] *Contract Audits: Role in Helping Ensure Effective Oversight and Reducing Improper Payments*, U.S. Government Accountability Office, http://www.gao.gov/new.items/d11331t.pdf

How contract audits can benefit your business

A well-executed contract audit can offer many benefits, including:

- Stronger contractor–owner relationships
- Averted penalties
- Early identification of potential compliance issues
- Support for favored vendor status
- Improved safety
- Fraud deterrence
- Fewer risks, costs, and delays
- Identification of areas for process improvement
- Good publicity in the marketplace.

Government entities may require contract audits that are tailored to regulatory requirements such as prevailing wage laws, use of disadvantaged business enterprises, limitations on overhead and profit, and how costs are categorized. Contract audits for private companies, in contrast, focus on cost recovery of overbillings or credits for work that was billed but not performed. Government, corporate, nonprofit, and private clients may all require verification of regulatory compliance with, for example, U.S. Occupational Safety and Health Administration (OSHA) regulations.

Fixed-price and cost-based contracts are the two basic types of contracts. Audits of fixed-price contracts focus on compliance with contract requirements and change orders. Audits of cost-based contracts focus on verification of the underlying costs and validation that costs are legitimate.

Controls are the key to passing a contract audit

Contractors with good internal controls in place and those that employ a systematic approach to fulfilling contractual obligations are generally less likely to have significant issues identified during the audit when compared to less-organized contractors. Those that establish a strong controls foundation and a standard and repeatable approach to controls can minimize construction risks and facilitate project success, especially on major capital projects spanning several years; their companies are better prepared to meet audit requirements. KPMG previously highlighted the importance of consistency in control standards in *A Controls-Focused Approach to Construction Risk Management,*[2] which noted:

> In our experience, one of the most common reasons for inconsistent controls and insufficient strategic risk management on construction projects is a lack of objective control standards. ... Industry-leading companies use a comprehensive set of objective criteria, which serve as a consistent baseline for controls evaluation and measurement. Such standards also can provide needed assessment criteria for internal audit departments.

A strong controls foundation can increase the likelihood that project outcomes are achieved and can lower audit surprises (such as the number and significance of identified deficiencies during an audit) by:

- Clearly defining project and contract roles and responsibilities
- Documenting a consistent process for contract bidding, negotiation, approval, and fulfillment of administration requirements
- Establishing clear and objective standards for managing and reporting all projects and contracts including change management, payment administration, and cost reporting
- Establishing clear guidelines for identifying, tracking, and reporting project issues or risks.

Developing a controls-focused approach

Developing and implementing a controls-focused approach to help manage a project's contract fulfillment process can help reduce risks, confirm that incremental project goals are being met, and reduce costs. Properly designed and implemented internal controls can make the difference between extensive cost overruns and a project delivered on time and within budget. We have found that these broad guidelines can help:

- *Set priorities.* Before determining the specific program governance structure, understand the objectives of the oversight program and the needs of the company as validated by company management and key stakeholders. Then establish project priorities.

[2] *A Controls-Focused Approach to Construction Risk Management* , *KPMG*, 2009

- *Develop a framework.* Develop and adapt a controls framework based on the company's needs, the program objectives, and priorities. Address critical areas, especially as they pertain to higher risk or cost.
- *Assess current controls.* Based on the determined framework, the company should perform a gap analysis of its existing core policies, procedures, and processes in order to identify gaps, overlaps, and areas of strength and weakness.
- *Strike the right balance.* Before implementing control recommendations, critically evaluate the controls that are being modified, implemented, or removed. Too many controls, or improper implementation of new controls, may be problematic.
- *Phase the implementation.* Modify controls or implement new ones in phases so that implementation issues can be addressed as they arise. Not all control changes may need to be implemented right away; for example, some may be needed only as a company grows.
- *Strive for continuous improvement.* Controls should not be stagnant. Rather, they need to be reassessed on an ongoing basis in order to monitor their effectiveness and ability to address new or emerging risks such as organizational changes or changes in the company's environment such as new regulations. Monitoring the company's controls and relevant risks is a critical component to maintaining an effective (and cost effective) controls framework.

Prepare for an audit on every project

Every E&C company would like to be prepared for an audit. In some situations, the contract specifies the time and type of audit that will or may be performed. In other situations, audits may be random or unplanned. Certain factors increase the likelihood of a contract audit. Government projects are more likely than nongovernment projects to require contract audits (and, in some cases, are mandatory). Larger projects are more likely to require contract audits than smaller ones. High-profile projects (whether private or government) are more likely to require audits than low-profile projects. Other factors that can precipitate a contract audit include poor contractor-owner relationships, funding-source requirements, large project overruns, allegations of fraud or misconduct, and regulatory mandates. The probability of an audit may increase if there is a large liquidated-damages element or lost-profits issue.

Cost, schedule, and scope are chief concerns

Auditors approach a contract audit with costs, schedule, and scope in mind. Among other procedures, auditors will likely verify that costs billed to the project are valid and reimbursable under the terms of the contract, review key contractual deliverables, and verify compliance with the agreed-on completion time line.

- *Cost:* Auditors likely will start with the contractor's latest job cost report and reconcile the amounts billed to the latest application for payment. A cost reconciliation prepared by the contractor that is included with the billings can help to facilitate this process. Based on the job cost report, auditors may select sample transactions for different types of costs such as materials, labor (exempt and nonexempt), equipment, subcontractors, general conditions, administrative, and overhead costs. They also will look for known "red flags" such as significant overtime, reclassification of costs, cost accruals, unusual or missing cost descriptions, large dollar amounts, round dollar amounts, costs incurred before the contract was executed, and home office overhead costs.

Good controls often result in fewer and less-severe deficiencies identified during an audit

Control examples include:

- Bid proposal review and approval
- Legal review and approval of agreements (including subcontracts)
- Review and approval of all change orders (including pricing)
- Review and approval of payment application package
- Frequent reconciliation of job cost report
- Quarterly project financial review
- Weekly or biweekly schedule reviews
- Internal auditing of all projects for contract compliance.

- *Schedule:* The auditor will look at the contractor's project schedule and make sure the project was completed within the original contractual time period plus any additional days authorized through change orders. If applicable, liquidated damages will be calculated on any delays occurring outside the authorized contract time.
- *Scope:* The auditor may also verify the receipt of required contractual deliverables. This is most commonly done during a contract closeout audit. The contractor may verify that key project closeout documentation such as warranties, operation and maintenance manuals, as-built drawings, and lien releases were appropriately produced by the contractor and provided to the owner.

Auditors may test a number of transactions from the job cost report and ask for supporting documentation. To check labor, they will likely ask for time cards, proof of payment, and labor detail reports. Additional support may be required to substantiate various components of the labor burden. For subcontractors and vendors, auditors typically want to review the original invoice and proof of payment. Any invoice that represents time and materials charges is expected to contain an adequate breakdown of units and unit costs.

Sometimes a contract is unclear about what constitutes a reimbursable cost. If the contract is ambiguous, the auditor often will quantify the amount of the questionable charges, categorize it as a "gray area," and discuss the intent with the owner and the contractor. Contract costs that frequently fall into this category include:

- Costs allocated to the contract that are intended to be captured though overhead mark-ups
- Costs allocated to and included in the labor burden
- Training
- Legal
- Travel and entertainment costs
- Personnel in similar roles (potential duplication)
- Major equipment purchases
- Equipment rental charges
- Significant equipment repairs
- Charges from related parties
- Certain change order costs

- Living and relocation expenses
- Project executive (or employees stationed in home office)
- Vehicles.

If the contract is silent about whether an expense is reimbursable, ask:

- Was this cost project specific? (That is, did any other project benefit?)
- Would the expenses have been incurred regardless of the project?
- Is the cost reasonable, and is there appropriate support?
- Does the expense fall within the owner's specifications (mileage rate, per diem, etc.)?

The contractor can be better prepared for an audit if it follows sound record-keeping practices. For example, relevant project documents should be filed and organized while the project is under way. Complete, readily accessible files help the auditor collect essential documents. A delay may raise the auditor's suspicion and cause the scope of the audit to expand. If an auditor's request is unclear, the contractor should ask questions and work with the auditor to clarify understanding. Unless specifically required, contractors should only provide document copies. If original documents are provided to auditors, contractors should keep a copy of what is provided to the auditor and label the documents with the corresponding number from the document-request list.

Contractors should organize change documentation on the job cost report in such a way that it can be easily reconciled to the amount shown in the report. This will allow the auditor to perform the audit without engaging in excessive searching and number crunching. If an explanation is needed, the contractor should discuss the item with the auditor to avoid misunderstandings.

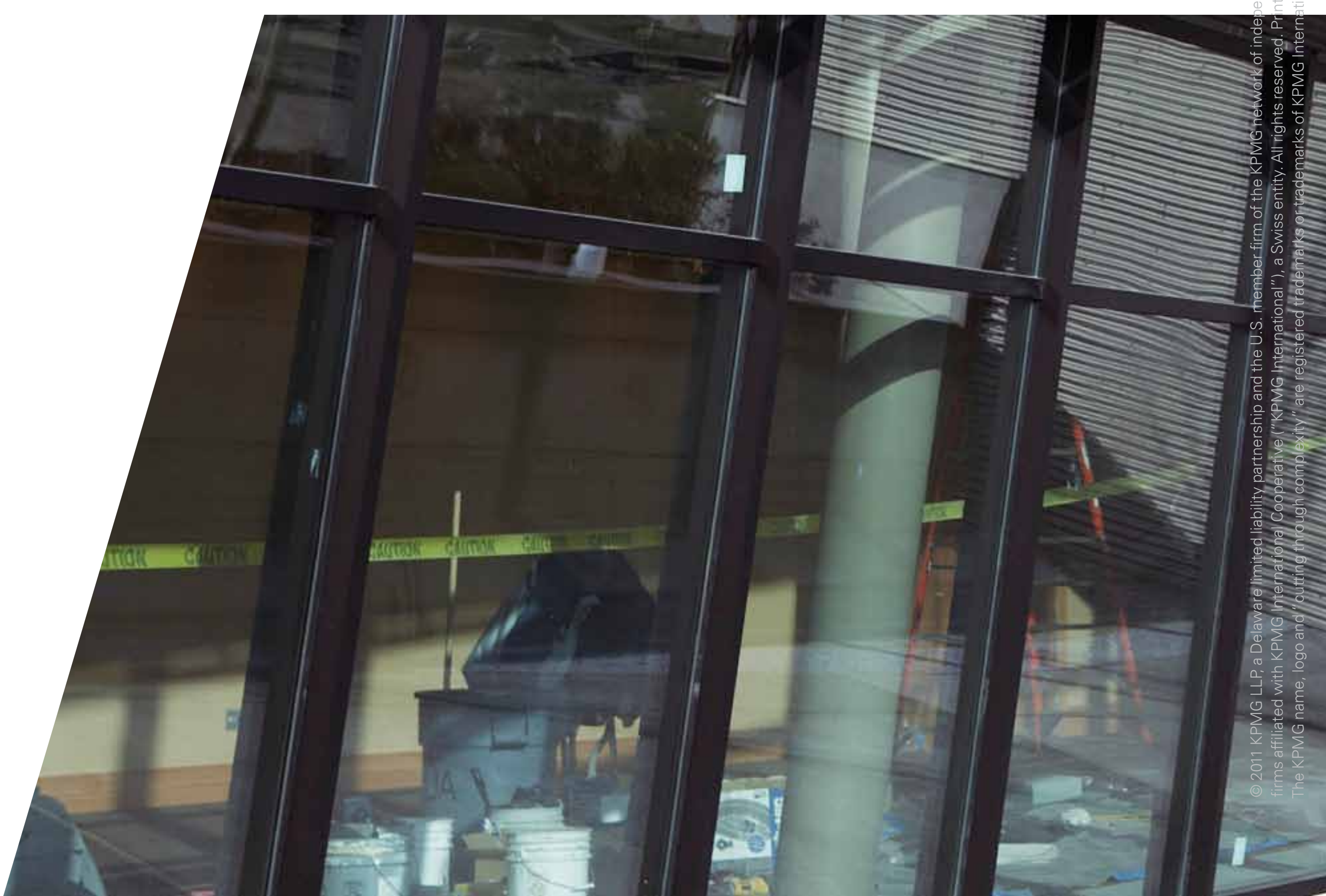
E&C companies should consider the feasibility of using a fully integrated job cost reporting and accounting system if one has not already been implemented. Such a system may provide visibility and control over project costs and can help minimize the likelihood of incurring project costs that are not reimbursable or not visible to the project team. An integrated system can make a contract audit much easier and may help avoid the necessity of having the project team manually reconcile project costs from multiple sources.

Good communication and documentation help ensure a smooth audit

A successful audit depends not only on good internal controls and sound business practices, but also on well-organized processes and good contractor–auditor communication. The contractor should appoint a primary contact for the auditor—preferably the project manager or individual with the most knowledge of the project. The auditor should set expectations for the audit's scope, process, and time lines and submit an initial documents-request list.

After completing field work but prior to issuing an audit report, the auditor usually will discuss potential audit findings and issues with the contractor. The auditor may propose audit adjustments based on the requirements of specific clauses in the contract. The auditor will note the relevant clause, present the auditor's calculated cost, and explain why the contractor's invoiced costs should be adjusted or disallowed. The auditor should provide the contractor with the opportunity to respond to each finding and to present additional supporting documentation to refute or clarify the contractor's accounting.

A contractor's defensive reaction to a contract audit can cause the owner and its auditor to also take a defensive position during discussions on audit findings or during claim-settlement discussions. Contractors that are prepared, however, and provide adequate support may be able to influence the direction of the audit in their favor. Being prepared and gaining consensus on any gray areas of the agreement are important goals for the contractor and should help to ensure a fair audit process.



Sound business practices may reduce the audit burden

Whatever the E&C project, these common business practices, if followed, can help reduce project risks and may reduce the audit burden (such as cost, time, or other disruptions):

1. Organize and assign clear responsibilities for managing and executing contract requirements at the outset of the project.
2. Have the project manager and project controls team take an active role in drafting all nontechnical documents. All contract documents should be consistent and complementary.
3. Perform a check of special contract terms such as allowance adjustments or insurance requirements, and do not guarantee new or untested processes or technologies.
4. Spend adequate time prequalifying subcontractors and work only with subcontractors with sufficient bonding capacity.
5. Solicit proposals from an adequate number of subcontractors and thoroughly review all pricing/proposals.
6. Maintain professional contract administration and document-management practices to protect the integrity of contracts (formal communication, document control, bill payment, timeliness).
7. Maintain detailed files of all costs billed to the owner and maintain adequate backup information for rates, markups, and pricing sources.
8. Independently validate subcontractors' price estimates for major scope packages, and implement enhanced controls for self-performed work.
9. Establish and maintain policies and procedures to manage and administer contracts, and establish high standards for documenting change orders and reimbursable costs.
10. Thoroughly monitor quantity and quality of work installed.
11. Integrate an effective construction audit function within the project policies and procedures.
12. Develop and review contract estimates to complete on a periodic basis.

Conclusion: Feedback fuels improvement

E&C companies have strong incentives to assess and enhance their project controls and maximize accountability and transparency. A contract audit may reveal misinterpretation of contract requirements, highlight discrepancies in key construction management processes, identify shortcomings in project documentation, or reveal errors in progress billings. The good news is that contractors can use this input to clarify misunderstandings and incorrect assumptions and improve controls and procedures.

Small, medium, and large E&C companies face similar challenges as they attempt to manage the risk exposures and avoid the pitfalls associated with construction contract audits. Given the intense scrutiny of construction cost overruns by government entities and private firms as well as the public's demand for transparency and accountability, E&C companies cannot afford to be reactive when addressing contract audits. Each contract audit represents an opportunity to improve management and administrative processes, strengthen internal controls, and develop stronger contract fulfillment skills.

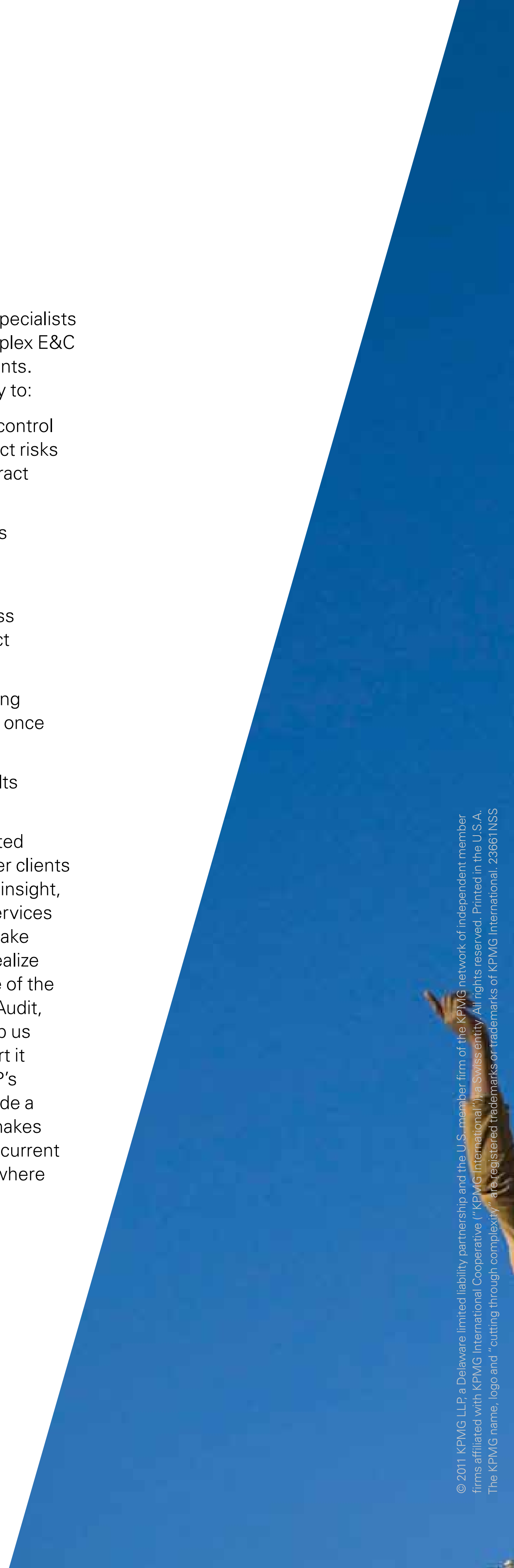
For contractors, implementing process changes based on "lessons learned" from the audit experience can minimize audit surprises and improve overall operations. Because the contractual audit clause often requires the contractor to absorb the cost of the audit if significant overcharges are identified, process improvements also can lead to a better bottom line. By assessing the state of construction project controls, applying a control structure that takes into account the requirements of construction contracts and implementing controls and sound business practices, organizations will be better prepared to deal with any construction audits that lie ahead.

KPMG can help

KPMG's construction advisory specialists understand the nuances of complex E&C projects and contract requirements. We can work with your company to:

- Implement an overall project control structure to help reduce project risks and to better prepare for contract audits
- Review construction contracts to address potential contract compliance issues
- Develop a self-auditing process to proactively address contract compliance issues
- Develop a protocol for preparing and managing contract audits once initiated
- Analyze and address the results of a contract audit.

KPMG member firms in the United States and around the world offer clients the scale, global reach, industry insight, and multidisciplinary range of services to enable your organization to make better business decisions and realize long-term value. Our knowledge of the E&C sector combined with our Audit, Tax, and Advisory services equip us to give your business the support it deserves and needs. KPMG LLP's partners and professionals provide a wide range of experience that makes us a significant resource in your current markets and in those locations where you may want to expand.



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