Reviewing construction costs

Anyone who has undertaken a major building project should determine whether the contractor or construction manager has complied with the provisions of the contract. Specifically, it’s vital to determine if the contractor has adhered to the contract provisions and whether there are overcharges.

There are three primary types of contracts: fixed price, where the contractor agrees to perform the work for a stated price; cost reimbursable, such as a guaranteed maximum price (GMP) contract where the contractor effectively passes through his costs to the owner and receives a fee; and unit price, where the payment is predicated on the quantity of work completed, such as miles of highway. The cost review procedures will vary depending on the type of contract.

Potential for cost recovery
With many costs, there’s a substantial likelihood of recovery, particularly when the contract is a cost-reimbursable contract. For instance:

**Labor rates**: Components of employee labor rates include employee base salaries and the associated labor burden, which includes customary benefits, such as vacation, sick leave, payroll taxes and retirement benefits. A determination should be made as to whether the benefit is mandatory and generally allowable in the labor burden, or discretionary, such as a contribution to a profit-sharing plan, and excluded or subject to owner approval.
Labor burden overcharges often occur in the following areas:

- **Payroll taxes**: Federal and state laws impose caps on the amount of payroll taxes an employer must pay on behalf of its employees. However, many contractors ignore these limitations, resulting in significant overcharges to the project.

- **Workers’ compensation insurance**: Many contractors purchase an insurance policy that sets rates for each classification of employee. These rates can be verified by comparing them to the insurance carrier’s audited rates. Large contractors will often establish a workers’ compensation reserve that must be analyzed to understand the basis for costs included in the labor burden and the appropriateness of these costs.

- **Employer pension and profit-sharing contributions**: The contractor will often include the amount of the maximum contribution percentage required by the retirement plan, although individual employees assigned to the project are either not enrolled in the plan or have elected a lesser amount of contribution than the maximum percentage allowed.

- **Overhead disguised as labor burden**: A detailed analysis of the labor burden will reveal whether non-reimbursable costs, such as computers, maintenance, training and accounting costs, have been included in the labor burden.

**Change orders**: A change order is an amendment to the construction contract, which usually relates to a change in the scope of the work, adjustment of the contract sum and/or the deadline for work to be completed. The threshold issue is whether the work included in the change order has already been included in the base contract.

The costs of a change order performed on a time and material basis include labor, materials, equipment and subcontractor costs. The contractor’s support for each change order should include time cards and work orders signed by the owner’s representative and copies of the invoices for material, equipment and supplies. A detailed breakdown of each subcontractor’s costs, including labor rates, should also be requested and analyzed.

All things considered, owners of construction projects should carefully weigh the benefits of conducting reviews of the construction costs against the risk of not doing so. A review will aid the owner in determining whether its assets or funds have been spent in accordance with the contract and will often result in the recovery of overcharges in excess of the cost of performing the review.

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Everyone’s concerned about fraud. Now, even greater anti-fraud efforts are anticipated after
the Auditing Standards Board issued a new fraud audit standard.

The new standard should make it more likely that auditors will detect material misstatements due to fraud in a financial statement audit. Auditors have a responsibility to plan and perform audits to obtain reasonable assurance that financial statements are free of misstatement caused by error or fraud. Given the nature and scope of the new standard, management should plan to provide auditors with more information and anticipate more extensive fraud detection procedures.

SAS No. 99 will require auditors to consider fraud risks and emphasize the importance of professional skepticism throughout the audit process. Depending on your existing control structure, management may need to more closely review its anti-fraud programs and implement stronger controls. Although that sounds like a lot of work, remember that prevention and deterrence are much cheaper and faster than time and expense required for fraud detection and investigation.

Fraud is often difficult to detect, but the risk can be reduced through a combination of prevention, deterrence and detection.

How will auditors assess risk areas?
SAS No. 99 recommends auditors discuss the following questions with management, internal auditors and members of the audit or finance committee:

- Is there any knowledge or suspicion of fraud?
- Are there specific fraud risks in the organization?
- What programs and controls mitigate fraud risks?
- How well does management communicate its policy on ethical behavior?
- Does the audit or finance committee receive and act on reports of risks and controls?
- Is the audit committee aware of or does it suspect fraud?
- Are the organization’s internal auditors aware of fraud risks and how are their findings addressed?

Remember that fraud detection isn’t solely up to auditors. Organizations should be wary of risk factors among employees, such as high turnover because of dissatisfaction; refusal to take vacations; and lifestyle or behavioral changes resulting in discrepancies between salary and lifestyle. Organizational factors can also be red flags, such as budget cutbacks resulting in a smaller workforce that feels pressure to do more with less; not checking account balances or reconciling bank statements in a timely manner; and failing to take strong action to correct fraud.

The fight against fraud begins with strong anti-fraud programs and controls that management should have in place to prevent and deter fraud. It continues with the auditor. By using expanded pre-engagement planning and brainstorming procedures, auditors will be looking for those financial pressure points or areas of risk associated with the client.

How can an organization reduce the risk of fraud?
Anti-fraud programs and controls, as discussed in SAS 99, include these key elements:

- Create and maintain a culture of honesty and high ethics.
- Develop a system to evaluate the risk of fraud and implement risk mitigation.
- Implement an appropriate oversight process. Oversight needs to take a tiered approach so that override at any layer, including the CEO (or mayor or executive director), may be identified and properly handled. The top layer of the oversight process is reserved for the audit or finance committee, which must ensure top management upholds its responsibilities to the organization.

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TE/GE boosts compliance efforts
The Tax Exempt/Government Entities (TE/GE) section of the IRS has signaled that it’s ratcheting up its compliance efforts this year by forming a special division to increase its compliance presence in the public sector community. What does this mean to your organization? Here are some issues to be concerned about:

Changes to Form 990
Form 990 for 2003 includes changes to help TE/GE identify organizations involved in activities that may be problematic.

First, disclosure of gaming activities included in special event revenue, including raffles, is now required. TE/GE will identify organizations conducting these activities and determine compliance with unrelated business income, withholding and reporting and other applicable laws.

Second, charities must disclose arrangements in which a donor retains the right to make suggestions about using funds they contribute. Such arrangements are akin to “donor-advised funds.” Upon disclosure, TE/GE may scrutinize whether the donor is allowed a deduction and whether the charity has met certain requirements to treat the fund as part of its organization. If these requirements are not met, the fund will be treated as a separate taxable entity.

IRS audits
Think twice if you’ve ever uttered the phrase, “what are the chances of being audited?” TE/GE has new methods to audit more organizations. Also, TE/GE is conducting market segment studies to gather industry data. Beware, however, that these studies are technically audits and organizations involved in a study may then be targeted for a traditional audit.

Additional TE/GE statements
TE/GE recently issued an article on compensation transactions that will be automatically treated as excess benefits and therefore subject to penalty. TE/GE continues to emphasize that it will emphatically enforce intermediate sanctions law.

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