

The Competitive Advantage of Construction Auditing

By Al M. Gray

As auditors we are all cognizant that the term “audit” consistently evokes the same reaction as “root canal,” “disc surgery,” or even “proctologic examination” – something likely to be painful and certainly unpleasant. However, the growing number of owners, developers, and even contractors who have overcome these notions and utilize construction auditing are enjoying a competitive advantage. Applying the strategy to a project frequently produces savings of 1 to 3% of costs. The moneys spent on auditing efforts typically provide returns unequalled by any other business activity.

Project dynamics require flexible auditing methods

Wizened construction hands object that traditional auditing methods will not work for their projects and are counterproductive. Yet that simplistic attitude is one of the contributing factors to the very costly canyon-like gap that exists between the construction and accounting functions. On large, complex projects the capital that falls victim to this interdisciplinary abyss may run into millions of dollars. Even on smaller projects considerable funds may be wasted. Construction auditing may be successfully employed to recognize and prevent these risks to capital at every stage of the project cycle from inception to completion.

The compression of time and spending during large projects creates an urgency that few in management truly appreciate. Truthfully, resistance to construction auditing has been fostered by auditors who have imposed traditional auditing methods on dynamic projects. The rapid pace at which most projects are prosecuted will not allow for business as usual - the laborious completion of audit programs, multiple management discussions, and reporting cycles of 90 days or more. Effective construction auditing detects, analyzes, and reports cost issues before they are set in concrete, doing so through the application of simplified reporting, proactive contract administration, contractor involvement, and assignment of experienced construction auditing personnel.

Misunderstood contracting realities are costly

There is a fundamental lack of understanding about contracting and subcontracting methods on the part of senior management for most owners. There is little recognition that preferred fixed, price contracting methods may not fit the realities of their project objectives, schedule, or management capabilities. Auditors can alert management early on that such disconnects exist, so that there is a better choice of contracting methodology. This capability prevents costly misunderstandings, discord, and claims later.

A similar benefit lies in the capability to use auditors in to evaluate and test contractor billing, cost accounting, and scheduling systems at the inception of a project. Supplementing project management with the analytical capabilities of the auditor allows for the early recognition of opportunities to limit, or avoid, costs through an informed evaluation of alternatives. For example, arranging for third party document duplication, distribution, and control versus using the engineering firm's in-house resources may reduce those costs from \$5,000 to \$150,000, depending upon the project size. Project insurance alternatives are another beneficial area for analysis.

Timely, accurate, and complete cost reporting is essential to project management during the project. Attaining and maintaining these attributes is made difficult by monthly billing cycles for subcontractors, lack of discipline in recording commitments, fragmentation of project cost data between contractor and owner, failures in the field change process, and even the loss of control over cash disbursements. The role of the auditor here is to test the cost reporting systems to determine whether project costs are accurately reported and that those systems are an effective tool for project management.

Achievable savings are diverse, yet can be substantial

Foremost among the reasons for capital project auditing are the huge savings achievable. These derive from proactivity during the contracting phase, analysis of change order costs, evaluation of claims, utilization of tax exemptions, verification of receipt of credits, labor cost analysis,

affirmation of costs for cost-plus contracts and a host of other sources. Like a mighty river is the summation of many trickles, springs, creeks, and streams, the savings become a torrent of costly mistakes avoided, tax exemptions captured, incentives maximized, backcharges collected, invoice errors corrected, overcharges eliminated, and other method savings. Whether the issue is a \$750 pricing error on a blanket order, a \$7,500 warranty claim, a duplicated charge of \$75,000, or a labor overbilling of \$750,000, each makes its own contribution toward a superior return.

Beyond construction auditing, there are tremendous opportunities in the areas of taxation, incentives, financing, equipment procurement, systems integration, maintenance contracts, and ongoing operations, which fall within the purview of comprehensive capital project reviews. The rewards for owners in capital-intensive industries from implementing comprehensive capital project and construction auditing have been so significant that their engineering or internal audit departments have separate units responsible for performing audits. The savings and cost recoveries generated by construction auditors usually exceed the costs of the entire internal audit department!

Sales/use taxation bedevils owners and contractors in many states, including the author's home state of Georgia. The state law designates that the contractor is the consumer and therefore the party responsible for the tax. Contractors are subject to a host of arcane regulations. Furthermore, the revenue statutes, regulations, and court rulings take away manufacturing and other exemptions by narrowly defining them. In this environment correct administration of taxes is difficult. The imposition of these taxes on contractor results in recoverable taxes buried in contracts, particularly electrical and mechanical subcontracts. The good news is that software applications make recovery of taxes within contracts achievable. Although not recoverable by the contractor, taxes are a source of savings for the owner that can gain the contractor some good will. As examples, one Georgia manufacturer was able to secure refunds and interest of more than \$950,000 in taxes paid by its contractor. Another reevaluated its exemption application and

obtained more than \$1.2 million in additional exemptions. Further opportunities abound for contractors in states where they are permitted to use exemptions, like North Carolina.

Its rarely too late, but delay in implementation can be costly in the extreme

One final thought about human tendencies and construction auditing – Don't procrastinate until the project is over before calling upon a construction auditor. Although auditing will likely produce a significant return, it may be unpleasant, only a fraction of the costs may be recoverable, and the most of the savings available at the beginning will be gone forever.

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