

# IIA Dallas Chapter Luncheon

Contract Risks and Controlling  
Costs

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**protiviti**<sup>®</sup>  
Risk & Business Consulting.  
Internal Audit.



## Introduction

- In today's contracting environment, no one wants to take on the risks. Depending on the contracting method, risks may fall on the Owner or the Vendor or both.
- We'll discuss risks in general with the different types of contracting methods and then focus on how to identify and control risks to cost in varying types of contracts.
- Contract cost recovery projects have consistently resulted in cost recoveries of 2-4% of the audited contract value.

# Service Contract Types

- There are multiple contracting methods used in business today.
  - Fixed Price or Lump Sum Type Contracts
  - Cost Reimbursable Plus Fee Type Contracts
  - Time & Material Type Contracts
  
- Each type of contract has its own risks with some risks applicable to all types.
  - We'll discuss those risks and what you should be focusing on.



## Brainstorming Risk Areas

- Let's brainstorm risk areas by contracting type. Think about what to focus on from an audit perspective.
  - Fixed Price or Lump Sum Type Contracts
  - Cost Reimbursable Plus Fee Type Contracts
  - Time & Material Type Contracts
- Take a few minutes and think about risk areas for each type of contract. Note that some risk areas may apply to multiple contract types.





## Fixed Price or Lump Sum Type Contracts

- With these type of contracts, most of the risks have been accepted by the Vendor.
- Here are some risk areas the Owner needs to be concerned with:
  - Percentage of Completion
  - Quality
  - Change Orders
- Let's hear what you came up with.



# Auditing Fixed Price or Lump Sum Type Contracts

- Percentage of Completion (POC)
  - Difficult to audit unless done in real time (physical progress)
  - Review the process to ensure POC is not inflated
- Quality
  - Difficult to audit unless you have the technical skills and knowledge
  - Review the process to ensure inspections occur and specifications are met
- Change Orders
  - Most likely area to audit for potential cost recovery
  - Select a sample or audit the entire population
  - Determine if change was for out of scope work (Vendor driven, Owner driven)
  - Audit the underlying support and usage of contingency





## Cost Reimbursable Plus Fee Type Contracts

- With these type of contracts, some of the risks have been accepted by the Owner and some by the Vendor if a cap or target price has been determined.
- Here are some risk areas the Owner needs to be concerned with:
  - Fee
  - General Conditions
  - Self-performed Work
  - Sub vendors
- Let's hear what you came up with.



# Auditing Cost Reimbursable Plus Fee Type Contracts

- Fee
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if fee was calculated per the contract terms
    - Normal Work
    - Change Order Work
- General Conditions
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Audit the underlying support
    - Labor (including burden)
    - Materials
    - Equipment
    - Expenses



## Auditing Cost Reimbursable Plus Fee Type Contracts (cont.)

- Self-performed Work
    - Audit for potential cost recovery
    - Select a sample of invoices / payment applications or audit the entire population
    - Audit the underlying support
      - Labor (including burden)
      - Materials
      - Equipment
      - Expenses
  - Sub vendors
    - Audit for potential cost recovery
    - Select a sample of sub vendors to audit
    - Determine if they billed more than contracted
- Risks involving Change Orders and Quality may also be present if a cap or target price have been negotiated.



## Time & Material Type Contracts

- With these type of contracts, most of the risks have been accepted by the Owner.
- Here are some risk areas the Owner needs to be concerned with:
  - Labor
  - Materials
  - Equipment
  - Expenses
  - Allowances
  - Rework/Warranty
  - Insurance/bonds
- Let's hear what you came up with.



# Auditing Time & Material Type Contracts

- Labor
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if labor hours and rates were billed per contract terms
    - Higher rates (ST, OT) / levels
    - Excessive / inflated hours
    - Billing ghost / terminated employees
    - Inflated labor burden
- Materials
  - Audit for potential cost recovery
  - Select a sample of payment applications or audit the entire population
  - Determine if materials were billed appropriately
    - Wrong project
    - Duplicate invoices
    - Excess materials



## Auditing Time & Material Type Contracts (cont.)

- Equipment
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if equipment hours and rates were billed per contract terms
    - Idle equipment
    - Higher / missing rates
    - Rent vs. buy
- Expenses
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if expenses were reasonable / appropriate
    - Travel
    - Meals
    - Entertainment
    - Discounts



## Auditing Time & Material Type Contracts (cont.)

- Allowances
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if allowance was billed along with expense
    - Relocation
    - Office supplies
    - Data processing
    - Mobile phones
    - Safety program
    - Vehicles
  
- Rework/Warranty
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine if work was previously performed and billed again



## Auditing Time & Material Type Contracts (cont.)

- Insurance/bonds
  - Audit for potential cost recovery
  - Select a sample of invoices / payment applications or audit the entire population
  - Determine the following:
    - Insurance/bond costs incurred were less than billed
    - Insurance/bonds billed but not obtained
    - Insurance/bonds refunds/rebates were not credited back to the project at close out



# Case Study

## Company Description

One of the nation's largest electric utilities with approximately \$19 billion in annual revenues. Company distributes electricity to approximately 5.4 million customers and gas to 485,000 customers. In addition, for energy delivery operations include energy generation and power marketing.

## Company Industry

Energy and Utilities

## Company Key Objective

Identify at least \$1.3M in 2009 in cost savings or recoveries from contractors/vendors within its business unit.



## Case Study (cont.)

### Nature of Work Performed

Utilized the following multi phase project approach:

- **Phase 1** - Performed risk assessment of active contracts (both Capital and Expense) to identify and stratify contracts with greatest potential for cost savings or recoveries.
- **Phase 2** - Performed substantive cost savings/recovery audits, updating risk assessment and universe of contracts to select for audit based upon reward/effort criteria.
- **Phase 3** - Reviewed Company's contract practices to identify areas for improvement to decrease the opportunity for contractor/vendor overcharges or other excess cost situations and assisted in implementation of proposed remediation actions.

### Key Project Outcome

Protiviti performed detailed reviews of 5 contractors/vendors for the initial pilot and identified \$4 million in recoverable costs:

- **Vegetation Management** - overpayments for meals, mileage, vacation charges, overhead expenses, unsupported labor and equipment rates, unauthorized OT, and warranty labor.
- **Landscaping** – overpayments for incorrect labor hours, crew rates, markups on subcontractors and expenses, and missing supporting documentation.
- **Snow Removal** - overpayments for travel time, inappropriate equipment charges, rate variances, overhead expenses, missing timesheets and subcontractor invoices.

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## Case Study (cont.)

### **Company Description**

A non-profit academic medical center that integrates clinical and hospital care with research and education. Client has locations throughout Northeast Ohio and beyond, including Canada, Florida, and Abu Dhabi. With more than 1,300 beds and 3.3 million patient visits each year, it is one of the largest and most respected hospitals in the country.

### **Client Industry**

Healthcare

### **Key Company Objective**

Leverage proven tools, methodologies, and experience along with knowledge of hospital construction in the healthcare industry to audit construction contracts managed by a Owner's Representative.



## Case Study (cont.)

### **Nature of Work Performed**

Client engaged Protiviti to perform a contract compliance and construction cost audit of a \$139M Cost Plus Guaranteed Maximum Price (“GMP”) Parking Garage and Operations Center to determine the following:

- Whether billings & payment are being made in accordance with contract terms,
- Whether sufficient controls are effectively operating over the payment process,
- That procedures are in place to monitor construction costs and project progress.

The audit focused on (1) Reimbursable costs, (2) Change Orders, (3) Self-performed work, (4) Markups, and (5) Miscellaneous expenditures (e.g., insurance and bond premiums, sales and use taxes, etc.).

### **Key Project Outcome**

Protiviti was able to identify almost \$1M in recoveries to pursue in the areas of markups on self performed concrete work, markups and calculation errors on GLI, and markups on commercial activity taxes. We also identified over \$1.1M in items needing reconciliation at project closeout, which would subsequently be kept by the general contractor if not reconciled. They included allowances (blueprints, waterproofing), allocations, permits, contingency discrepancies, schedule of value updates, GLI charges on change orders, markups on deductive change orders, markup calculation errors on change orders, contractor incentive payments, and commercial activity taxes.



## Other Risk Areas to Consider in Today's Economy

- Vendor Working Capital/Cash Flow
  - Inflated percentage of completion (prime, sub)
  - Aggressive completed work calculations (commitments, accruals, change orders, etc.)
  - Delayed payments to sub vendors (potential for liens, walk offs, financial instability)
- Vendor Accounting and Back Office Support
  - Not core competency
  - Lots of projects/paper/manual activities
- Material and Equipment Security
  - Theft of material and equipment
  - Disposition of excess material and scraps
- Let's discuss other risk areas that may be affecting your industry.



## Wrap Up

- Brainstorming
- Fixed Price or Lump Sum Type Contracts
  - Risk Areas
  - Audits
- Cost Reimbursable Plus Fee Type Contracts
  - Risk Areas
  - Audits
- Time & Material Type Contracts
  - Risk Areas
  - Audits
- Other Risk Areas to Consider in Today's Economy
- Closing Comments/Thoughts

## Contact Information



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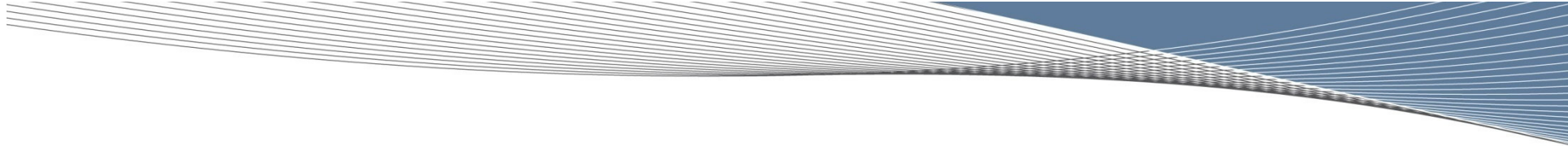
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