



Identifying and Managing Risks on Construction Projects

POWERFUL INSIGHTS

Issue

In a challenging economic climate, contractors feel the pinch. Projects are cancelled, backlogs dry up and prices decline. To compensate for reduced projects and decreased revenues, contractors must scramble to win or save work while maintaining positive cash flow. By doing this, they can reduce their working capital needed to pay employees, suppliers and subcontractors. Such circumstances demand that owners who are looking to construct or finish a capital project in a short timeframe pay close attention to the contractor's progress and billings. Many contractors today are billing owners as fast as possible even though physical progress may be less than costs incurred, and are delaying payments to suppliers and subcontractors in order to conserve cash.

For example, consider a cost-reimbursable contract with a guaranteed maximum price. While there may be some expenses incurred by the general contractor (GC) for general conditions and self-performed work, a majority of costs come from fixed-price or lump-sum subcontracts. Billings from subcontractors typically are based on percentage of completion estimates, which are determined by progress (physical, costs, hours, etc.). To maintain positive cash flow, the GC wants to ensure the percentage of completion is as high as possible, even though physical progress may not be in line with costs or billings (e.g., physical progress may be at 40 percent, with costs at 50 percent and billings at 60 percent). At the same time, while the GC is collecting payments from the owner for potentially inflated progress, the GC may be delaying payments to suppliers and subcontractors in order to maintain positive cash flow.

Challenges and Opportunities

These issues create several risks for owners, including contractors having billings in excess of actual costs incurred. Contractors typically refer to this as BIE in their financials. From a progress perspective, such billings may be greater than physical progress. Therefore, the contractor could walk off the project and not suffer even though retainage may be taken by the owner. Another risk for owners is delays in contractor payments to suppliers and subcontractors. When suppliers and subcontractors are not paid in a timely manner, liens may be issued against the project, which the owner may have to settle. They also may not deliver critical equipment on time or at all, and may even walk off the project, leaving the owner to hire another contractor or even subcontractors to finish the project. These risks further complicate projects that may already be at risk of being completed on time and on budget.

Our Point of View

We recommend several preventive and detective processes to employ in any project. From a preventive standpoint, owners should review processes and controls that will help manage and monitor these risks, such as contract management and invoice review processes. Owners can then address gaps in processes and controls to ensure risks are appropriately mitigated, and add resources to help manage and monitor these risks throughout the project lifecycle. From a detective standpoint, owners should review current progress and billings to ensure these risks have not occurred. If these risks have occurred, owners can improve processes and controls to ensure they are mitigated as the project continues toward completion. The goal is to recover costs (detective) and reduce future cost overruns (preventive). ➤

PROVEN DELIVERY

How We Help Companies Succeed

Protiviti reviews owner and contractor processes and controls that help manage and monitor risks during major capital projects. We identify gaps in processes and controls that should be addressed to ensure risks are appropriately mitigated. Protiviti provides resources to help manage and monitor these risks throughout the project lifecycle. These resources augment owner and contractor accounting, project management and construction management teams. In addition, we review reported progress and billings to ensure these risks have not occurred, and help owners and contractors improve processes and controls to mitigate these risks as the project progresses. We also help owners recover costs and reduce future cost overruns.

Example

A premier healthcare institution hired a general contractor to construct a \$25 million research building addition and a \$100 million outpatient facility. Cost increases and schedule delays prompted management to engage Protiviti to audit a sample of payment applications associated with the construction contracts between the hospital and the contractors. Each construction project

was performed under a cost-reimbursable contract with a guaranteed maximum price. The client brought in Protiviti because of our proven tools, methodologies, experience and knowledge in construction contract auditing within the healthcare industry.

Protiviti's audit objectives were to:

- Select a representative sample of payment applications to gain at least 30 percent coverage of current construction spend for each capital project.
- Determine the appropriateness of the charges, accuracy in billings and compliance with contractual provisions.
- Assist the client in identifying any process or control environment improvements.

Protiviti's audit detected significant issues with contractor billings, including progress billings from subcontractors. Issues included labor/equipment rate errors, labor burden overcharges, markup miscalculations, allowance duplicates, excessive and/or unreasonable expenses, and missing documentation. Protiviti identified more than \$4 million in contract exceptions and provided detailed recommendations on how our client could reduce future cost overruns through improved controls and processes.

Contacts

Marcus Delouche
+1.713.314.4982
marcus.delouche@protiviti.com

Paul Pettit
+1.713.314.5031
paul.pettit@protiviti.com

About Protiviti

Protiviti (www.protiviti.com) is a global business consulting and internal audit firm composed of experts specializing in risk, advisory and transaction services. The firm helps solve problems in finance and transactions, operations, technology, litigation, governance, risk, and compliance. Protiviti's highly trained, results-oriented professionals provide a unique perspective on a wide range of critical business issues for clients in the Americas, Asia-Pacific, Europe and the Middle East.

Protiviti has more than 60 locations worldwide and is a wholly owned subsidiary of Robert Half International Inc. (NYSE symbol: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.