



DOES YOUR CONSTRUCTION PROJECT HAVE ADEQUATE CONTROLS?

By John Croy,
CIA, CPA, CFE

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As construction in the gaming industry continues to increase, learn how internal auditors can help combat fraud throughout the project – from awarding contracts to project closeout.

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The number of gaming industry construction projects is on the rise, which represents major investments for owners. Unfortunately, situations like the one described in the sidebar "Fraud in the Contract Award Process" happen with some regularity. To ensure owners receive the goods and services they are paying for, and to make sure the proper controls are in place to protect employees, internal auditors need to make sure key controls are in place for addressing the processes in the general construction project's life cycle.

The following paragraphs offer ways for internal auditors to help owners reduce their risks, provide clear direction for the contractors, and reduce the potential for conflict during construction.

Awarding Construction Contracts

Two primary concerns exist during a project's contract award phase: using the appropriate contract and establishing adequate controls. The latter is achieved by selecting the appropriate type of contract and negotiating terms favorable to the owner.

The contracts used most frequently are stipulated sum and cost reimbursable plus a fee. Today, most gaming contracts are cost reimbursable with a not-to-exceed amount or guaranteed maximum price (GMP). These contracts typically result in projects being completed on time and within budget.

It is quite common for a contractor to participate in the project's design phase,

Fraud in the Contract Award Process*

As the procurement manager for a major gaming company, Joe Smith solicited and received bids for extensive maintenance and expansion projects.

Although qualified contractors were required to submit bids by a specified date and time, there was no formal bid-opening process. Instead, Smith received all bids and opened them in his office. He then called his friend at ABC Construction and revealed the bids. Based on this information, ABC submitted the lowest bid and was awarded the contracts.

Some time later, it was learned that ABC Construction performed construction work at Smith's home in return for the work at the gaming company.

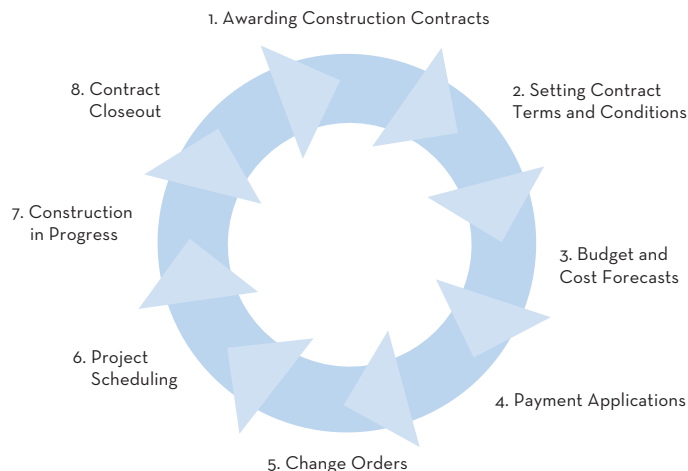
* This situation is provided as an example only.

which involves developing the specifications for the new facility. Once the contract documents are 95 percent complete, a GMP is negotiated. Often, the contractor will begin construction prior to negotiating the final GMP contract to ensure timely project completion. When this occurs, however, it increases the risk that the contractor will not agree to, or will delay setting, a GMP. The financial risks transfer to the contractor at the time the GMP is finalized, so delaying or not agreeing to setting a GMP reduces the risks to the contractor. The earlier a GMP is established, the better for the owner.

Controls for the project's contract award phase include specifying a date and time when bids are due. When there are multiple bids, all bids should be opened and logged at the time they are due. A minimum of three employees should be present at the

Continued on page 2

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bid opening, and at least one person should represent an area other than procurement or purchasing. This ensures fairness in the bidding and evaluation process. Occasionally, an internal auditor should also observe this process.

Setting Contract Terms and Conditions

The American Institute of Architects (AIA) provides standard construction contracts. For example, AIA 101 and AIA 111 reflect stipulated sum and cost reimbursable contracts, respectively. The contracts, however, may not have the necessary terms and conditions to protect the owner.

AIA 101 for stipulated sum (or defined sum) contracts, for example, does not include a right-to-audit clause. This clause is important because it allows the owner and its representatives to access the contractor's accounting records. For stipulated sum contracts, the right-to-audit clause is used to validate cost estimates for change orders and to ensure materials used are in accordance with the contract.

AIA 111 for cost reimbursable contracts contains provisions defining allowable and unallowable costs. Basically, any project cost incurred at the project site is allowable, while costs incurred away from the project

site, or home office costs, are not. The risk is that the contractor will invoice for costs not allowed in the contract. The owner should review contract attachments to ensure they are consistent with the intent of the contract.

Budget and Cost Forecasts

During construction, auditors should monitor project costs on a regular basis appropriate to the project. This is generally performed on a monthly basis. It is imperative to quickly discover whether the project will exceed its budget so the owner can take corrective action.

The owner's project manager must ensure the project budget and cost forecast contains the following components:

- Original budget
- Budget changes
- Revised budget
- Actual cost incurred
- Commitments to date (such as agreements for goods and services)
- Uncommitted costs (such as agreements for goods and services not in place)
- Estimated cost to complete or final estimated cost

Continued on page 3

The project's operating system software should provide budget components – items such as the original budget and actual cost incurred. The project management team should provide the estimated cost to complete the project. At approximately 25 percent of completion, the auditor will be able to assess the estimated project completion costs.

Applications for Payment

Applications for payment are frequently submitted on AIA form G702: Application for Payment with AIA form G703: Continuation Sheet. The contractor certifies the applications for payment, and they are approved by the architect and the owner's project manager or representative. This approval usually includes a high-level review. And because Jefferson Wells calculates that approximately 50 percent or more of applications for payment contain mathematical errors, invoicing for unapproved change orders, or invoicing for fees and services not provided, auditors should verify their financial accuracy against a checklist and perform procedures to:

- Determine whether the contractor is invoicing for unapproved change orders
- Ensure the application for payment is mathematically correct
- Determine if the invoice is for services provided

Change Orders

Change orders represent a high risk on all construction contracts. The owner's objective is to pay a reasonable price for services provided. This is generally dictated by a competitive bid process or by paying the contractor for costs as they occur. Change orders do not meet those requirements. The change order is generally negotiated between the contractor and owner's project manager or representative.

Often, the owner reviews the change order to make sure it is reasonable but does not validate costs or determine whether the costs were included in the original bid. An example of this is an owner paying for a computer three times – once in the original bid and twice through change orders. And while it's essential for the owner to review or audit significant change orders, it must be done in a manner that does not delay the construction schedule. Internal audit can assist in the process by validating the estimated cost included in the change order to the cost actually incurred.

Project Scheduling

Without a doubt, the most critical element of a gaming construction project is the timeliness of project completion. Timeliness affects the owner's return on investment and investor expectations. More and more contracts contain provisions related to the construction schedule, such as liquidated damages and fee incentives tied to the schedule. Like the budget, the project schedule should be reviewed by the project manager, with an updated version provided to management on a monthly basis. That way, if the project schedule begins to slip, management can determine whether to accelerate the current schedule.

Because many contracts are laden with financial provisions related to the schedule, any contract change orders should include the potential impact on the completion date.

Construction in Progress

The construction in progress (CIP) account accumulates construction costs before assets are placed into service. For certain types of construction projects, a CIP account may be used to fund the costs before the asset or service is provided.

Management should establish policies and procedures to identify costs included in the CIP account. Costs incurred by the contractor and other costs (such as design costs) are typically included in the CIP account. Generally, the CIP account includes:

- Payments to the general contractor
- Payments to the architects
- Payments to third parties directly involved in the project (surveyors)
- Internal incremental labor cost directly associated with the construction project
- Interest expense pursuant to Statement of Financial Accounting Standards No. 34: Capitalization of Interest Cost

The CIP account generally excludes the following:

- Internal labor and associated costs that are not incremental or directly associated with the construction project
- Cost of any project opening and closing ceremonies

Deciding when an asset is placed into service is an important consideration, requiring a standardized assessment process. For example, trucks and computers may be placed into service before a new facility opens. These assets, therefore, may need to be amortized.

Project costs accumulate in the owner's project cost system, which may or may not be integrated with the financial accounting system. Regardless, the project cost system should be reconciled to the CIP general ledger account on a regular basis to ensure accuracy of the financial statements.

Contract Close-out

At the project's conclusion, the owner should have assurances that the contractor has completed the work in accordance with the contract. The project architect's final inspection and sign-off provide assurance

the structure was built according to the plans and specifications. A close-out audit assures the owner that the costs billed complied with the contract terms.

Policies and procedures are necessary to assure the owner that the following have occurred:

- All lien releases have been received, ensuring payments have been made for goods and services
- Procedures are in place to ensure that punch list items are completed
- If the project is a cost reimbursable project, a close-out audit was performed to validate costs incurred by the contractor

The owner should withhold retainage from the contractor to protect against any performance-related issues until all work has been completed by the contractor and approved by the owner.

Summing It Up

Gaming entities are known for the strong internal controls they use in managing their core businesses. On construction projects, however, they often place all their trust in the contractor and architect. With budgets for gaming construction projects skyrocketing into the billions of dollars, gaming entities cannot ignore implementing controls to reduce their financial risks. Establishing adequate controls and developing an internal audit process to ensure the controls are effective reduces the owner's risks, provides clear direction for the contractors, and reduces the potential for conflict during construction.

John Croy, CIA, CPA, CFE, is Director of the Construction Services Center of Expertise in the Internal Audit and Controls practice of Jefferson Wells.

He can be reached in the Phoenix office at 602-643-1600 or john.croy@jeffersonwells.com.