CONSTRUCTION FRAUD PREVENTION AND DETECTION

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Introductions

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Outline

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- Learning objectives
- Working definitions
- Construction process
- Risks of construction
- Construction delivery methods
- Controls audit program review

Working sessions

- Project internal control self assessment
- Development of risk matrix/understanding of high risk areas
- Fraud assessment
- Controls – preventative and detective

Closing comments

Learning objectives

Participate in interactive case studies that begin at preconstruction activities and go through final walk-through to prevent construction fraud and mitigate construction project risk. Case studies will cover:

- Choosing the right construction delivery method
- Mitigating risk through effective contracting
- Designing project controls that complement project management, not hamper it
- Detecting and preventing construction fraud

Learning objectives (cont.)

Participants will be able to evaluate the project controls environment to identify project roles and responsibilities, skills and capacity issues, and potential project risks that will be used to develop a construction project risk management program. Additionally, participants will:

- Gain the knowledge to differentiate between construction fraud, negligence and carelessness
- Learn contracting strategies that minimize construction financial risk
- Apply concepts learned during the session in case studies to understand where in the construction cycle risk exists and how it may be mitigated

Working definitions

Aggressive billing practices:

- The charging of premium prices for goods and services required during the course of construction while complying with contract terms and conditions.

Abusive billing practices:

- The billing for goods and services that are almost in compliance with the contract and are frequently not in the owner's best interest.

Working definitions (cont.)

Fraud – by definition:

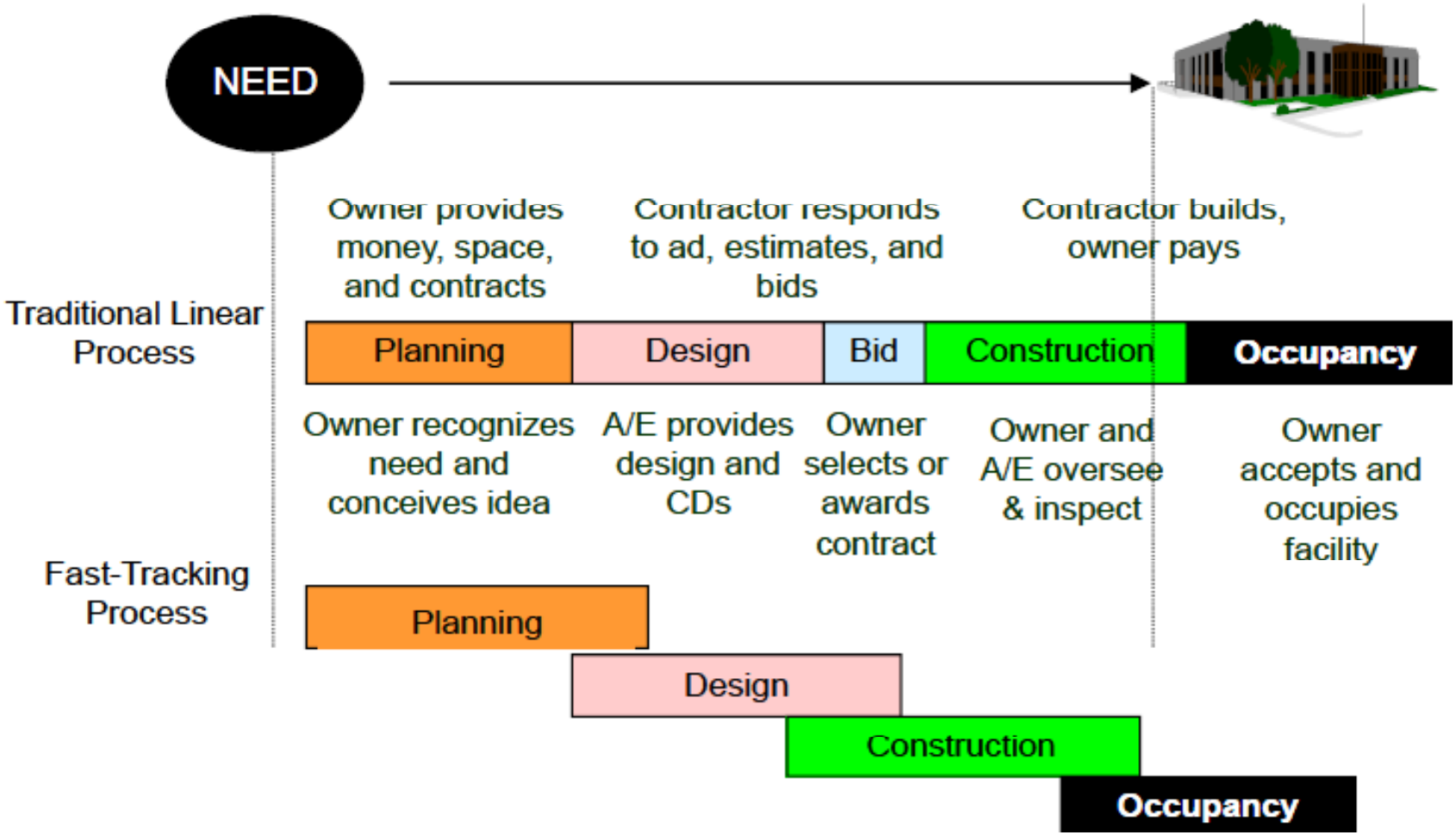
- Deceit, trickery, sharp practice, or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage.
- A particular instance of deceit or trickery: mail fraud, election fraud.
- A person who makes deceitful pretenses; sham; poseur.

Working definitions

Fraud – broad legal definition:

- There must be a deliberate misrepresentation of the product's condition and actual monetary damages must occur.

Construction Life Cycle




Owner Responsibilities
Owner's Rep
Internal Control
Architect
Construction Manager
Pre-Construction
Feasibility & Design
Contractor Selection
Contracting Process
Pricing Provisions
Change Order Pricing
Contingency Budget Control
Allowable and Non-allowable Expenses
Owner's Right to Audit
Owner's Responsibilities
Construction
Change Order Control
Change Order Pricing
Progress Reporting
Change Order Scope
Project Controls
Budget Reporting
Cash Flow Reporting
Estimate to Complete
Contract Accounting
Schedule Management
Business Ethics Compliance
Document Compliance Requirements
Design, Plan & Spec. Compliance
Contract Compliance Pricing
Contract Compliance Service Provided
Post-Construction
Financial Reconciliation
Shared Savings Calculations
Contingency Reconciliation
Allowances & Credits Reconciliation
Closeout Reporting/Cost Audit
Final Walk-through Punch List

Construction project risks

Construction risk assumed by owners

- Project delivery method
- Design failure
- Structural failure
- Scope creep
- Financial
- Contract compliance
- Billing fraud
- Completion delays
- Loss of stakeholder confidence
- Cost inflation
- Policy compliance
- The unknown…

Mitigating construction risk

- Prevent and recover overcharges
- Provide independent financial reporting of true construction project costs
- Comply with contract terms and policies and procedures
- Enhance project controls
- Satisfy stakeholders
- Meet compliance requirements
- Mitigate financial risk

Managing stakeholder expectations

Organizational behaviors and compliance:

- Unethical bidding practices
- Unreasonable organizational polices and procedures
- Unethical hiring practices
- Uninformed project stakeholders
- Overlooked local or disadvantaged businesses
- Improper communication

Project delivery method

Three major options:

- Competitive Bids (Lump Sum) (Design-Bid-Build or DBB)
- Negotiated (Construction Manager (CM) At-Risk)
- Design / Build (DB)

Design-Bid-Build

Possible advantages

- History / precedence / familiarity
- Designer and builder checks and balances
- Owner control of, and input on, design
- Program (basis of design) can be less developed
- A/E (architect / engineer) remains owner's agent throughout construction
- Contractor (should be) motivated to execute quickly to reduce its costs
- Easiest to evaluate offerors (if low bid)

Design-Bid-Build

Possible disadvantages

- Owner liable for design errors and omissions
- Owner is middleman in A vs. C disputes
- Requires 100 percent plans and specifications
- Time – cannot begin construction until design finished
- No contractor input during design
- Potential for "bid bust"
- Unknown contractor qualifications (if low bid)

Design-Bid-Build

A/E cost responsibilities

- Cost estimating by A/E
- A/E reviews bids
- A/E reviews Change Orders
- A/E reviews Progress Payments (not subcontractors and suppliers)
- A/E reviews Final Payments

CM At-Risk

Possible advantages

- Like DBB
  - Designer and builder checks and balances
  - Owner control of, and input on, design
  - Program (basis of design) can be less developed
  - A/E remains owner's agent throughout construction
- Like DB
  - Flexibility with speed of delivery
  - Builder input during design
  - Voice in staffing and subs (possible)
  - Open-book construction accounting (usually)

CM AT-Risk

Possible disadvantages

- Like DBB
  - Designer and builder checks and balances
  - Owner liable for design errors and omissions
  - Owner is middleman in A vs. C disputes
  - Requires somewhat detailed plans and specifications
- Like DB
  - Harder to evaluate offerors (as process usually includes technical evaluation)
  - Quality second fiddle to time? (caution)

CM At-Risk

A/E cost responsibilities

- A/E participates but not responsible for cost estimating
- A/E reviews bids
- A/E reviews Change Orders
- A/E reviews Progress Payments (not subcontractors and suppliers)
- A/E reviews Final Payments

Design-Build

Possible advantages

- One selection; one contract
- Speed of overall delivery
- Builder input during design
- Voice in staffing and subs (possible)
- Open-book construction accounting (possible)
- Minimization of builder vs. designer disputes
- Designer and builder checks and balances

Design-Build

Possible disadvantages

- Owner and subs unfamiliarity with method
- May compromise designer and builder checks and balances
- Need thorough program (basis of design)
- Partial loss of control over design
- Harder to evaluate offerors (as process usually includes technical evaluation)
- Quality second fiddle to time? (Caution)

Design-Build

A/E cost responsibilities

- A/E not responsible for cost estimating
- A/E does not review bids
- A/E does not review Change Orders
- A/E does not review Progress Payments
- A/E does not review Final Payments

Common findings

Common construction audit findings:

- Inflated labor burden rates, overhead, general condition charges, procurement burden and markup
- Misstatement of material and supply quantity
- Errors in material quantity conversions
- Excessive general condition charges
- Duplicate invoices and charges
- Lost owner deposits and allowances
- Abusive change order management and change order pricing
- Unallocated owner credits and value engineering savings

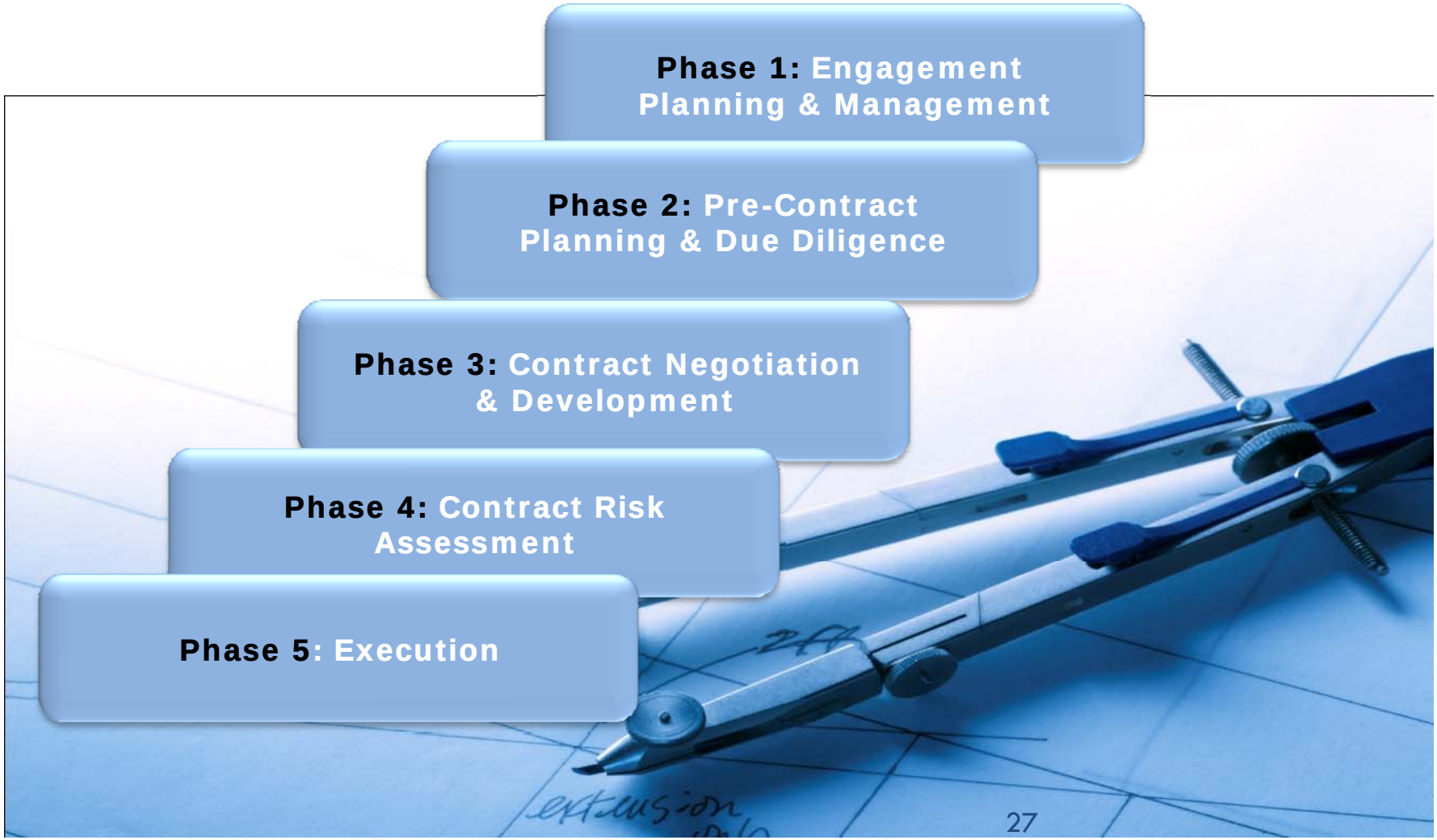
Risk Mitigation Methodology

Construction audit program fundamentals:

- Identify contract and construction risk
- Document and analyze construction process controls
- Test financial controls for weakness and/or compliance
- Reconcile contractor's cost calculations with source documents
- Verify contractor's cost calculations with contract terms
- Recommend and implement financial control improvements
- Validate continued testing with cost/benefit analysis
- Tailor test programs to focus efforts on highest and most exposed construction financial risks

Program Methodology

Methodology



Methodology

Phase 1: Engagement planning and management

- Identify engagement stakeholders
- Evaluate and understand stakeholders' perceived construction project risks
- Communicate owner's engagement goals
- Communicate engagement expectations
- Determine stakeholders' tolerance for risk
- Develop communication protocol

Methodology

Phase 2: Pre-contract planning and due diligence

- Establish contracting goals and objectives
- Establish development team's roles and responsibilities
- Determine contracting methodology: Lump sum, guaranteed maximum price (GMP), cost plus
- Develop contractor qualification criteria
- Establish bidding process
- Develop bid award criteria
- Develop shared incentive methodology
- Develop owner communication requirements

Methodology

Phase 2: Pre-contract planning and due diligence

- Develop project performance reporting requirements
- Develop project cost and financial reporting requirements
- Develop owner's right to audit requirements
- Develop value engineering requirements
- Develop procurement specifications
- Establish change order procedures
- Establish liquidated damages requirements
- Establish insurance, guarantee and warranty requirements

Methodology

Phase 3: Contract negotiation and development

- Review project bids
- Financial stress test contractors
- Identify substitutions and clarifications
- Reconcile bid pricing differences
- Assist with contractor interview
- Assist with contractor evaluation
- Establish project documentation and backup requirements
- Determine contract administration responsibility

Methodology

Phase 4: Contract risk assessment

- Review development contract(s) for owner's risks
- Develop owner's risk matrix
- Determine potential financial impact of risks
- Determine potential probability of risks
- Prioritize owner's risk matrix

Methodology

Phase 5: Execution

Achieve the objectives

Minimize

- Construction project cost escalation

Lessen

- Owner / architect / contractor conflict

Supplement

- Construction knowledge base

Reduce

- Administrative burden

Mitigate

- Construction financial risk

Breakout sessions

Project Internal Control Self Assessment

Respond to the following as it relates to your organization's last major construction / capital project:

1. What steps were taken to pre-qualify contractors and subs?
2. Were any errors discovered in the monthly contract billings? If so, how much and how often? Why?
3. What type of contract was it? (GMP, T&M, lump sum, etc.)
4. Were there any change orders? Who approved the change orders? Were pricing provisions related to the change orders verified with contract provisions?
5. Did the contract come in on time and on budget? If not, why?

Project Internal Control Self Assessment

(cont.)

Respond to the following as it relates to your organization's last major construction / capital project:

6. Was a final contract accounting completed? Who completed it and what did it look like? Was the report provided to the board or audit committee for review?
7. Were reconciliations of owner contingencies / allowances/ shared savings completed? Were any errors found?
8. Were all errors, internal control, and project findings reported to the board or audit committee?
9. Did the board or audit committee require periodic progress reports? If so, what did they look like and how frequent?

Development of risk matrix/ understanding of high risk areas

Contract Provision	Provision Reference	Type of Exposure	Mitigating Action	Objective
Contractor shall be liable for liquidated damages in the amount of five hundred dollars per day for each and every day "substantial completion" is not achieved by the deadline stated in Contract Documents.	Agreement Page 2: Article 4	Without a specific definition of "substantial completion," the contractor could contest the definition and whether damages should be assessed for not meeting deadlines per the contract. ABCDE could forgo revenues and liquidated damages.	Purchasing Manager should coordinate with the project manager a clear definition of "substantial completion" in contract documents.	Ensure contractor is aware of work product expectations and avoid disputes.
95% of material and equipment not incorporated in the work but delivered and suitably stored may be included in progress payments.	Agreement Page 3: Article 7.1.1	Without a specific definition of "suitably stored," the contractor and owner could contest the definition ABCDE could be paying for material and equipment costs that are not used in the project.	Purchasing Manager should define "suitably stored" in contract documentation as it relates to equipment and materials for this contract. Contract Administrator should review materials and equipment delivered. This includes reviewing progress payments for materials needed for project completion.	Ensure contractor and ABCDE have the same understanding of "suitably stored." Verify materials and equipment delivered as defined in the contract.
List of Subcontractors and suppliers for R.L Rider & Company.	Subcontractors & Suppliers Exhibit 6 Page 1 - 2	Subcontractors are not pre-qualified or approved by ABCDE	Procurement and project managers should verify subcontractor lists prior to bid letting.	Prevent awarding contracts to unauthorized contractors.
Mobilization cannot exceed 3% of the total of all other items.	Unit Prices Page 1	Excessive mobilization costs	The contract should define allowable costs that are included in the mobilization calculation. Verify only allowable costs have been used in the calculation of mobilization charges.	Ensure mobilization costs are for qualified "mobilization" amounts and total amount does not exceed 3%.
Schedule of unit price contract documentation.	Unit Prices Page 1 - 14	ABCDE could pay more per unit price than what is stated in the contract.	Verify unit prices charged to contract unit price rate schedules.	Ensure ABCDE is not overcharged and the correct unit prices are used.

Fraud assessment

1. Has fraud ever been discovered during your construction projects? If so, what was it? How much did it cost? What was your organization's reaction to the fraud?
2. Does your organization have a written plan to communicate fraud? Does it address construction activities? Is there an established method to communicate this (e.g., hotline)?
3. Are your construction personnel provided with construction fraud training?
4. Is fraud reported to law enforcement? Is it required?
5. Does your organization have a plan to react when / if fraud is detected?
6. Do you have the capacity and capability to investigate potential fraud situations?
7. Can you effectively investigate fraud if it does not involve an employee (i.e., subcontractor)?

Controls – preventative & detective

What would you do?

Situation: The director of facilities is demanding that all architects submitting proposals for development / design hire his child.

Controls – preventative & detective (cont.)

What would you do?

Situation: The general contractor billed rents for self-performed work for equipment not used on the jobsite.

Controls – preventative & detective (cont.)

What would you do?

Situation: The CM provided your owner's representative with tickets to the Super Bowl. In return, the CM billed for work not completed and used labor burden rates not agreed to.

Controls – preventative & detective (cont.)

What would you do?

Situation: The CFO arranged for the general contractor to complete a construction project at his vacation property and billed it through the project at $75,000.

Controls – preventative & detective (cont.)

What would you do?

Situation: The contract called for the general contractor to provide insurance coverage for the project and submit proof of insurance. After an insurance claim was made, it was discovered that there was not adequate insurance in place and the insurance certificate was falsified.

Controls – preventative & detective (cont.)

What would you do?

Situation: Contract change order billings were submitted for items covered in the original contract, for work not performed and at incorrect labor rates.

Controls – preventative & detective (cont.)

What would you do?

Situation: The general contractor received rebates and incentives from key material suppliers (including a worker's comp refund), which were not passed through to the owner.

Controls – preventative & detective (cont.)

What would you do?

Situation: The concrete subcontractor used a lower grade product on the floors and shared the savings with the general contractor's foreman.

Controls – preventative & detective (cont.)

What would you do?

Situation: The superintendent of the plumbing contractor took materials from the jobsite each weekend and sold it to the salvage yard for cash.

Closing comments

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