Fundamentals of a Construction Audit

August 7, 2014
Agenda

- Definitions
- Risk Based Approach
- What Determines Risk
- Fraud
- Construction Risks
- What to Audit
- Red Flags
- Why Audit
- Prevention
- Wrap-up
Definitions

- AIA
- Allowances
- Architect
- As-builts
- Change order
- Contractor
- Consumables, expendables and small tools

- Contingency
- Design Builder
- Fast Track
- General Conditions
- Labor
- Owner
- Owner representation
- Retainage
- Project Site
- Self Performed Work
- Shared savings

- Stored Materials
- Subcontractors
- Tiered subcontractors
- Trades
- Value Engineering
Risk Based Approach

- Size ($ value and physical size)
- Type of contract
  - Cost Plus and T&M versus Lump Sum
  - Shared Savings Features (to calculate and make sure it’s done right)
- High profile or high risk projects
- Experience of Owner’s PM, Rep, GC, or CM
- Mandate from senior management or audit committee

- Risk – Based on contract type!
What Determines Risk

- Lump Sum, Fixed Price, Stipulated Sum
  - Competitively Bid
  - Negotiated (TINA)

- Cost Reimbursable or Cost Plus
  - Cost Plus with Fixed or Percentage Fee
  - Guaranteed Maximum Price
  - Time and Material
  - False Claims Act
What Determines the Contract Type

- Design
- Schedule
- Price Competition
- Location
- Regulations
Construction Risk

- Cost
- Quality
- Schedule

Construction Triangle
Organizations

- Owner
- Project Manager (Owner’s Representative)
- Architect and Engineer
- Contractor
- Subcontractor (trades)
Fraud Statistics

- **ACFE Statistics:**
  - Median fraud loss in construction is $245,000*
  - Seventh highest fraud loss amount by industry*

- **ACFE Common Construction Fraud Schemes (two or more):**
  - Corruption - 57%*
  - Billings – 22%*

- **Construction Cost recovery Potential:**
  - Easy way for IA to quantify value add
  - 2% of total contract value is potential overpayment amount
  - Average ROI ratio of 10

- **Internal Fraud, Waste and Abuse**
  - Procurement

* Per The ACFE’s 2014 Report To The Nations On Occupational Fraud and Abuse
Behavioral Red Flags

- Close Association with Vendors
- Wheeler Dealer Attitude
- Excessive Pressure
- Control Issues

* Per The ACFE’s 2014 Report To The Nations On Occupational Fraud and Abuse
Stipulated Sum - Risks

- Procurement process
  - Bid rigging
- Specifications
  - Outside specifications
  - Quantities not installed
- Change orders
  - Incremental cost – not including in contract value
  - In accordance with the contract
- “Front-end” or “top-loading”
- Allowances
- Prevailing Wage Rates
- Stored Materials
Stipulated Sum – Red Flags

- Less than 3 bidders
- More than 8-10 bidders
- Money left on the table
- Unsuccessful bidders doing subcontract work
- Subcontractor complaints
- Contingencies or allowances
- Excessive change orders
Change Orders
Specifications
Stored Materials

Stored Materials Invoiced

- January: $400,000
- February: $600,000
- March: $1,400,000
- April: $2,000,000
- May: $400,000
- June: $200,000

Delivered After Invoiced
Invoiced
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Contract value</td>
<td>$754,168</td>
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<td>Previous work in place</td>
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<td>Previous stored material</td>
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<td>Current stored material</td>
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<tr>
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<tr>
<td>Percent complete</td>
<td>100 %</td>
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<tr>
<td>Balance to finish</td>
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Cost Reimbursable - Risks

- Billings in excess of cost
- Labor – Fringe Benefits
- Insurance
- Materials
- Equipment
- Subcontractor
  - Self Performed Work
- Fee
Billings in Excess of Cost

- Allowed to bill the lesser of percent complete or actual cost.
- Job cost report
- Payment application
- Job cost should equal amount completed and stored to date less fee
Labor Cost

- Labor distribution report – integrates with job cost system
- Home office labor
- Excessive fringe benefit costs (25% to 40%)
- Unallowable cost in fringe benefits
- Duplication of compensated personal absence
- Time not worked
- Excessive overtime
- Negotiated rates
Insurance Cost

- Traditional Insurance
- Owner Controlled Insurance (OCIP)
- Contractor Controlled Insurance (CCIP)
- Subcontractor Default Insurance (Subguard)

Issues
- Insurance not required
- Agreed upon rates
- Rates to be applied on cost
- Increase profits by at least 1%
Materials

- Excess materials
  - Trace to specifications
  - Delivered to different address

- Taxes
Equipment

- Equipment
  - In use – compare to labor
  - Insurance
  - Source: internal or third party

- Autos – Trucks
  - Equipment pool – audit pool
  - Allowance – included in compensation
  - Third party rental
Subcontract

- Self performed work
- Lien waivers
- Trace change orders with owner to subcontractors
- Cost reimbursable – high risk
- Clean-up
- Backcharges
- 90% of cost
- Check licenses
- Terminated subcontractors
Fee

- Recalculate fee
- Fee percent complete should equal overall job percent complete
Cost Reimbursable - Red Flags

- Staffing
- Low Fee
- Fixed rates
- More than one subcontractor on a trade
- Different shipping address
- Self Performed Work
Over Charges

- Labor
- Excess Billings
- Insurance
- Miscellaneous
Time and Material - Risk

- Improper classification
- Improper rates
- Billing for costs in the rates
Architect Engineer

- Labor classifications
- Reliance on work
- Review change orders for entitlement
- Prototype design
Why Audit?

- Potential over billings
- Ensure owner receives deliverables
- Protect against irregularities
- Built in accordance with specifications
- “Low hanging fruit”
Preventative Measures

- Verification of the contractor qualifications
  - Financial statement review
  - References
  - Track record with this company

- Contract terms and conditions

- Review licenses

- Audit – construction life cycle
QUESTIONS?
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