Construction Fraud:
Stories from the Field
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We will be recording today.
Introductions

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Introductions

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Today’s topics

> Learning objectives
> Types of construction fraud
> Auditing to detect construction fraud
> Activities to mitigate construction fraud
> Fraud stories:
  – Direct Labor
  – Billing
  – Vendor Negotiation
Why are we here today

1) Understand common fraud schemes associated with construction projects
2) Learn fraud risks and audit procedures to identify fraud schemes related to construction contracts
3) Recognize activities to mitigate the risk of fraud related to construction projects
4) Learn from fraud stories from the field
Key Construction Activities

- Design and construction team has been selected (Facilities)
- Contracts have been executed (Legal)
- Construction is complete (Facilities)
- Move in day is past and project records are archived
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<td>Final Walk-through Punch List</td>
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Owner’s responsibilities

Where can fraud occur in pre-construction activities? How can you help prevent fraud at this stage?

> Contractor due diligence
> Contracting and negotiation
> Contract risk matrix development
Where can fraud occur during the construction phase? How can you help prevent fraud at this stage?

> Controlling capital expenditures
> Monitoring change orders
> Scheduling thousands of activities for hundreds of people
> Maintaining an ethical and safe work environment
Where might you find fraud post construction?

> Closeout audits
> Shared savings calculations
> Compliance versus controls
> Allowance reconciliation
> Final pay application reconciliation
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
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 (e.g., mail fraud, election fraud)

> A person who makes deceitful pretenses; sham; poseur

Fraud – broad legal definition

> There must be a deliberate misrepresentation of the product’s condition and actual monetary damages must occur
### Types of fraud related to construction

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<tr>
<th>Category</th>
<th>Description</th>
<th>Statistics</th>
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<tbody>
<tr>
<td>Billing Schemes</td>
<td>Any fraud scheme in which a person causes his or her employer to issue an irregular payment for goods or services</td>
<td>Median Loss: $128,000 Median Duration: 24 Months</td>
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<td>Non-Cash Misappropriations</td>
<td>Any scheme in which an employee steals or misuses a non-cash asset</td>
<td>Median Loss: $90,000 Median Duration: 15 Months</td>
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<td>Corruption</td>
<td>Employee’s use of his or her influence in business transactions for the purpose of obtaining a benefit for him or herself or someone else</td>
<td>Median Loss: $375,000 Median Duration: 18 Months</td>
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<td>Payroll</td>
<td>Any scheme in which an employee causes an irregular compensation payment</td>
<td>Median Loss: $72,000 Median Duration: 24 Months</td>
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Report to the Nations, Association of Certified Fraud Examiners, 2010
Fraud Case Studies

Report to the Nations, Association of Certified Fraud Examiners, 2010
Fraud Case Study: Repairs and maintenance

Facts

- Annual repair budget $30 million
- Repair work is sole sourced to a large local contractor who is a major donor to the institution
- Work orders with budgets are issued for each repair project
- The price for the work is competitive and consistent with other construction estimates
- Supporting documents for invoices are verified and appear to be in good order
Where was the owner defrauded on this work?

> Repairs were made by salvaging materials from the repair site and reusing them to make the repairs

> Materials and supplies that were purchased for the repair work and billed to the owner were stockpiled into the contractor’s inventory
How was this detected?

> Baker Tilly worked with Facilities to inspect the completed work and identified window casings that were nicked and cracked

> Our follow up review of the waste removal invoices uncovered too little waste had been sent to the landfill

> Our subsequent interviews with construction crews discovered they had been instructed to salvage and reuse as much material as possible
What was the estimated cost of this scheme?

Over a three year period, the Owner had been defrauded by over $1,000,000.
Billing schemes

Methods

> Billing equipment or personnel at rates that are higher than agreed upon rate tables
> Miscalculating rate increases
> Pay application or invoice arithmetic errors
> Billing for costs not associated with the project
Facts

> Trusted contractor with over 20 years invested in the relationship
> Major contributor to the institution’s charitable foundation
> Trusted personal friend of the President and Chairman of the Board
> New Facilities Director coming on board asks for a construction audit as due diligence effort
Where was the Owner defrauded?
> The lobby and fireplace that had been donated by the contractor for the building had been billed to the Owner

Additionally, what did the construction audit find?
> Construction contracts were poorly written and very one sided
> The Owner had agreed to pay a two percent warranty fee when industry practice is there is no charge for warranty work
How did these findings change business practices?

> New construction contract templates were written based on well controlled contracting practices
> The contractor has been banned from future work at the institution
> Gift and entertainment policies were changed to prevent employees and officers from accepting high value gifts
> Owner refused to accept the terms of the financial settlement
> Owner shares this story with peers at association meetings
Fraud Case Study: Billing

Facts

> Owner has an annual construction budget in excess of $100 million
> Master services agreements have been negotiated with several contractors to help ensure competitive pricing and reliable resources
> Internal audit performs a limited construction audit of the projects on a annual basis
> Audit reports never revealed any significant findings
> Project is on time and on budget; correct arithmetic on invoices and change orders followed policy and procedure
Where was the Owner defrauded?

> Equipment was billed as higher rates than were agreed to in the master services agreement
> The billing rates used were newly negotiated with an effective date in the future from the date of work
> Invoices were billed late to imply the work dates coincided with contract effective dates
> Invoices were intentionally mislabeled with the wrong contract code linking the invoice to contracts with higher billing rates
How was this detected?

An observant project manager noticed that one invoice had different billing rates for the same piece of equipment, which was also used during the same time period and at the same location and became curious.

Baker Tilly then worked with the institution to perform a full construction audit. We tested 100% of the billed transactions from a particular vendor and helped to identify items for a multi-million dollar settlement.
Material fraud

Methods

> Material substitution
> Incorrect material measurements
> Failure to credit for unused materials and supplies
> Failure to credit for Owner direct purchases
> Installation of substandard materials
Fraud Case Study: Materials

Facts

> Owner contracted to build a $12 million parking structure
> Significant excavating and site preparation was required due to site conditions
> Site preparation budget was over run by 100%
> Poor ground quality required many extra trucks of gravel
> Unusual amounts of rain compounded the site condition problems and delayed the construction schedule
Case Study: Material fraud

Where was the Owner defrauded?

> This resulted in a higher price per ton of gravel than the trucking tickets represented
  - Gravel is typically sold by the ton
  - The unusual weather had significantly raised the moisture content in the gravel increasing the weight of a cubic yard of gravel
Case Study: Material fraud

How was this discovered?

> Internal audit was performing an interim audit of the project and noticed the major site preparation budget overrun

> After Internal Audit and Baker Tilly interviewed the project manager the auditor learned that the project had been affected by the recent rains, which explained the overrun. This prompted the auditor to ask the project manager, why does rain cost a project so much money?

> The project manager went on to explain all of the tasks impacted by rain.

> During the course of this discussion they realized that the aggregate they had been purchasing hadn’t been price adjusted for moisture content.
Fraud Case Study: Corruption

Facts

> Owner uses competitive bidding to procure contractors
> Bids are submitted sealed and opened under strict observation and recording procedures
> Bids are closely grouped and prices reflect historical experience
> Project is awarded to low bidder
> The owner has a great experience with the contractor and is happy to give the contractor a reference
How was the Owner defrauded?

The winning contractor had been bribing project managers at two of their closest competitors to share confidential bid information enabling the contractor to prepare and submit the lowest bid.

Let’s consider the ethics of how an Owner operates.
How was this detected?

> During the annual process of approving contractors for the next year a project manager noticed one contractor had been awarded an unusually high number of bids.

> This prompted Internal Audit and Facilities, working with Baker Tilly, to analyze the bid tabulations from each project awarded the last twelve months.

> The analysis found too many close bids, which lead to a deeper investigation and ultimate discovery of information leaks.
ACUA Annual Conference
September 11-15, 2011
The Tropicanaa, Las Vegas, NV

Next ACUA Webinar
August 10, 2011
“Why Ethics are Needed When the Law Governs”
Additional resources

> www.acua-l@associationlists.com
> www.bakertilly.com/construction-audit-webinar
> http://www.theiia.org/
> https://www.thenaca.org/
> http://www.caacci.org/
> http://rsmeans.reedconstructiondata.com/
> http://www.auditnet.org/
Questions?

Please feel free to ask questions in the screen to your right.

We will answer as many questions as time permits.
Thank you for participating today! Remember CPE certificates will be mailed to you by ACUA Headquarters in about three weeks.

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Disclosure

Required firm disclosure and Circular 230

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