

# The Role of Forensic Accountants in Audits and Construction Cases

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# Construction Projects

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## The Basics

# Construction Projects

## 4 Major Factors:

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1. Scope
2. Cost
3. Time
4. Quality

## Measured By:

1. Contract Value
2. Contract Schedule
3. Fitness for Purpose

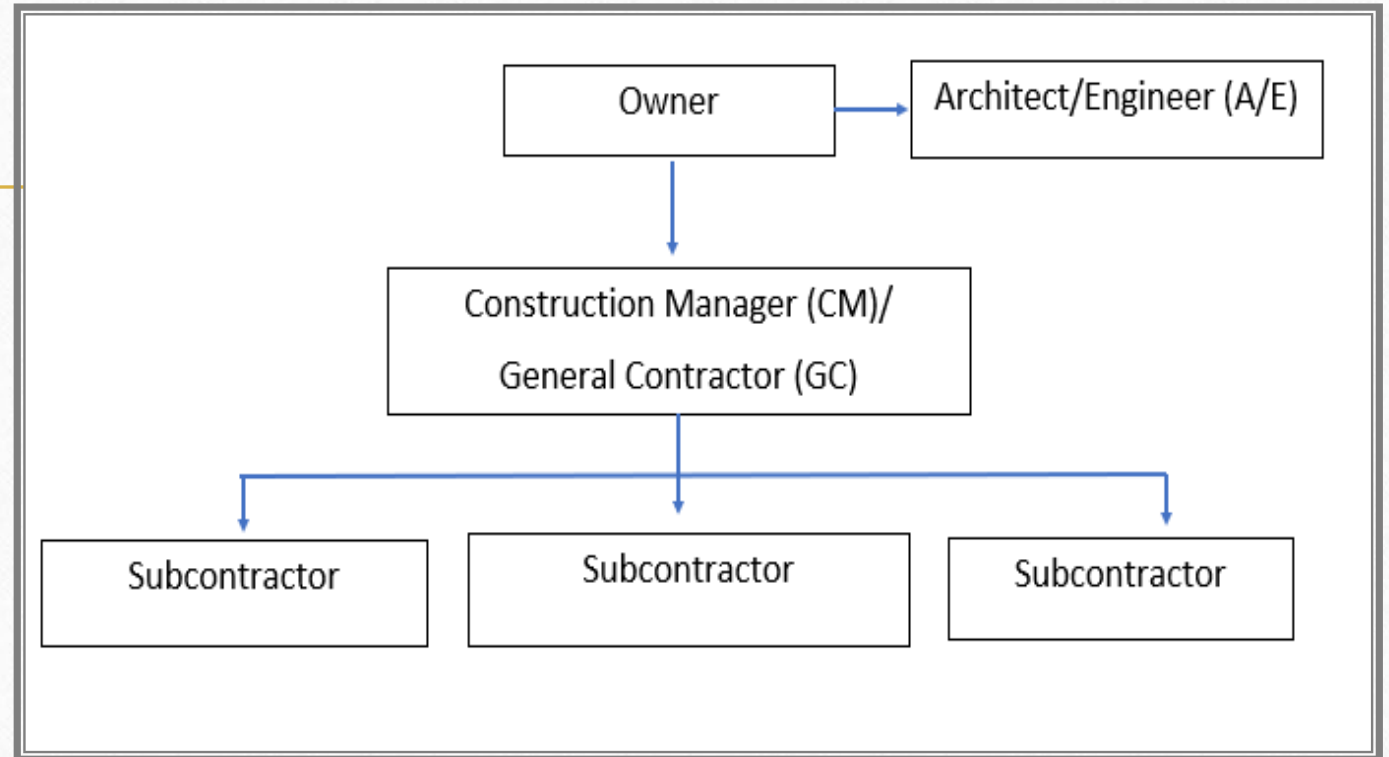
Events and issues with these factors can force losses on a project or result in an inferior product being built.

# Typical Parties to a Construction Contract/Project

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Any party can file a claim.

Note that contract language may limit the types and / or magnitude of the claims that a party can bring.



# Possible Third Parties Involved in Construction Claims / Disputes

## Examples of Possible Third-Party Claimants or Respondents

- Consulting Engineers
- Material Suppliers
- Equipment Suppliers
- Property Developers
- Facility Tenants
- Financiers

## Insurers Providing Coverage to Parties Involved in a Construction Project

- Payment & Performance Bonds (P&P Bonds)
- Professional Liability
- Builders Risk
- Owner Controlled Insurance Program (OCIP)
- Contractor Controlled Insurance Program (CCIP)

In some cases, insurers are liable for the damages incurred by the damaged party. It is not uncommon for insurance companies to be involved in the litigation process, whether actively directing the case or providing support to the insured.

# Construction Contracts: Common Pricing Arrangements

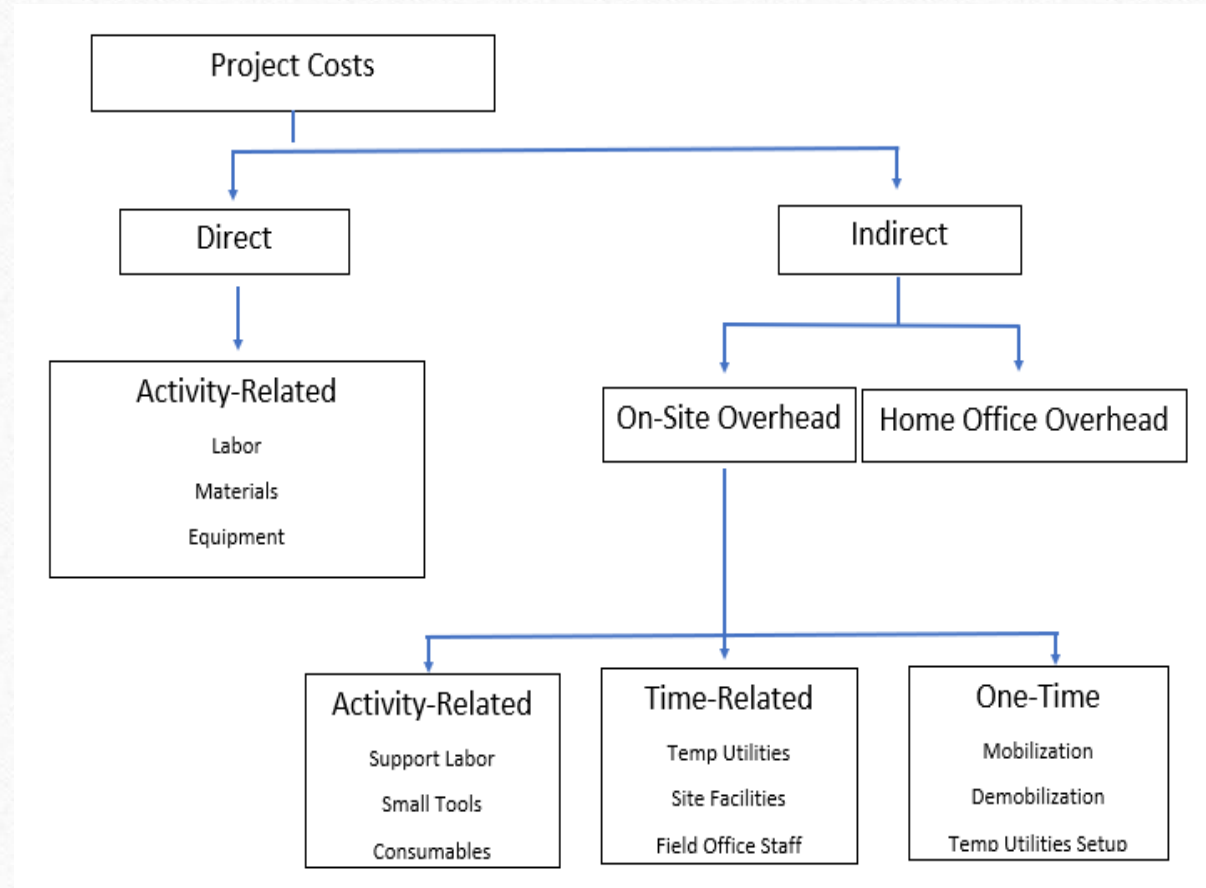
- **Fixed-Price** – Price of project is agreed upon by all parties and can only be altered by approved change orders (CO).
- **Cost-Plus** – Contractor's cost for the project plus a predetermined fee.
- **Guaranteed Maximum Price (GMP)** – The agreed upon price is the maximum the Contractor can charge the Owner without an approved CO to increase the GMP.
- **Unit Price** – Commonly used to price CO work and when a quantity of certain materials to be installed is unknown when negotiating a contract price.

# Contract Language

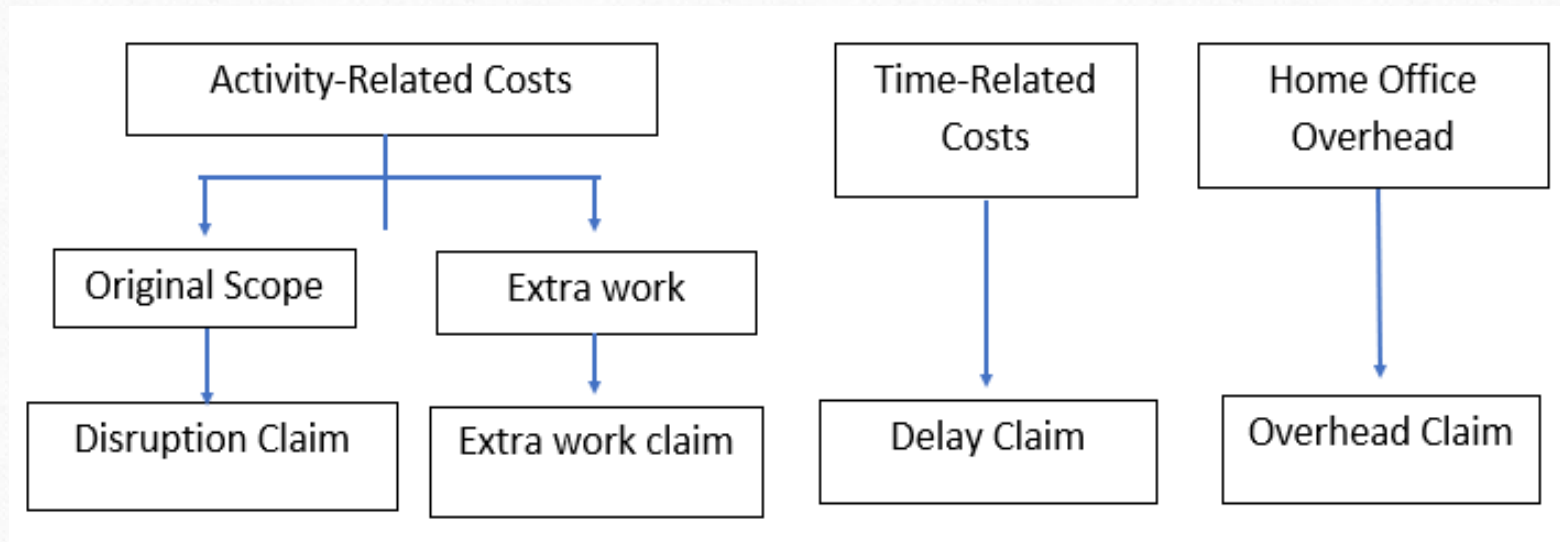
- Parties to a project should understand the contract terms before execution
- Experts **MUST** understand the terms of the contract when evaluating and calculating damages
- Contracts often:
  - Outline how damages are to be calculated
  - Limit the losses recoverable
  - Have conditions that must be met for damages to be recoverable
- AIA Contract Language (Article 11 Accounting Records):
  - Contractor should pay attention to the definition of records and accounts in order to preserve them properly in case of audit
  - Standard to require Contractor keep Project Accounting Records for 3 years after final payment (or longer if required by law)
  - Article 11 can be modified during contract negotiations, i.e., confidentiality clause for Contractor's records, more defined records requirements or definitions to ensure an audit can produce, with reasonable certainty, that the costs associated with the project are legitimate

## Job Cost Accounting – Job Cost Pools

1. Direct Costs - costs identified with a final objective or outcome
2. Indirect Costs - costs NOT identified with a final objective or outcome BUT identified with either:
  - a) 2 or more final objectives or outcomes
  - b) at least 1 intermediate outcome



# Segregation of Cost Pools and Types of Damage Claims



# Job Cost Accounting and Damage Claims

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- CM/GC should internally track costs for each project separately, thereby making it easier for the Damages Expert to track, support, and quantify specific costs related to a damage claim
  - Damage Experts start by reviewing the “Job Cost Ledger” where all costs associated with the project (except overhead from the company’s home office) should be detailed
  - Proper supporting documentation is key for relying on the assertions made regarding the claim
  - The calculation by the Damages Expert must be defensible, both in the damages report and subsequent testimony
    - This relies on having appropriate and adequate documentation from the damaged party

# Types of Claims

## Contractor Claims

- Delay
- Disruption (Loss of Productivity)
- Acceleration
- Changes in Scope of Work
- Extra Work
- Termination
- Lack of Payment
- Lost Profit

## Owner Claims

- Delay (Liquidated Damages)
- Termination
- Lost Profit
- Fraud
- Misrepresentation
- Defective Work

Most disputes involve more than one type of claim. Often claims may result from the same source. Each claim should be analyzed separately to determine damages.

**Important to Note: NOT ALL DAMAGES ARE RECOVERABLE**

# Delay Claims

The number of workdays a project was completed after the agreed upon completion date

- Calculation:
  - **Actual Completion Date – (Agreed Completion Date + Agreed Extension Days) = Delay**

Scheduling Expert:

1. Determine what event or party caused the delay
2. Classify Type of Delay
  - a) Inexcusable – within CM/GC control but not Owner, results in no additional time or money to CM/GC
  - b) Excusable – outside control of both CM/GC and Owner, results in additional time but no money to CM/GC
  - c) Concurrent – within control of both CM/GC and Owner, results in additional time but no money to CM/GC
  - d) Compensable – within Owner control but not CM/GC, results in additional time and money to CM/GC

Damages Expert - Relies on the conclusions of the Scheduling Expert, as well as the documentation to support the economic damages, in order to quantify the damages and issue a report / testimony.

# Disruption Claims

Any change in project conditions, methods, or work sequencing that affects the CM/GC project performance relative to the plan contemplated at the time of bidding the project

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## Often Results in:

- Loss of production or efficiency in contractor labor and equipment
- Increased costs

## Engineering Expert:

1. Define and isolate the cause(s) of the disruption
2. Establish causation between the source(s) of the disruption and resulting effects on labor and equipment

Damages Expert - Relies on the conclusions of the Engineering Expert, as well as the documentation to support the economic damages, in order to quantify the damages and issue a report / testimony.

\*Activity related costs are usually utilized to calculate losses.

# Extra Work Claims

Owner changes the agreed upon scope of work

## **Contractor Should:**

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- Follow the contract guidelines for additional costs / time for extra work
- Document the additional costs and time incurred separately from the original scope of work
- NOT start work on unapproved changes as it puts the CM/GC at risk of not being paid for costs incurred

## **BEWARE of Scope Creep:**

- Keep track of minor changes throughout the project as they can add up to significant additional costs
- This type of extra work hard to identify and quantify because there is not one major change
  - Real time documentation is key to being able to support your claim

Damages Expert - Relies on the documentation to support the economic damages, in order to quantify the damages and issue a report / testimony.

\*It is possible additional experts might be utilized to opine on certain aspects of the extra work.

# Construction Audits

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## The Role of the Forensic Accountant

# The Forensic Accountant

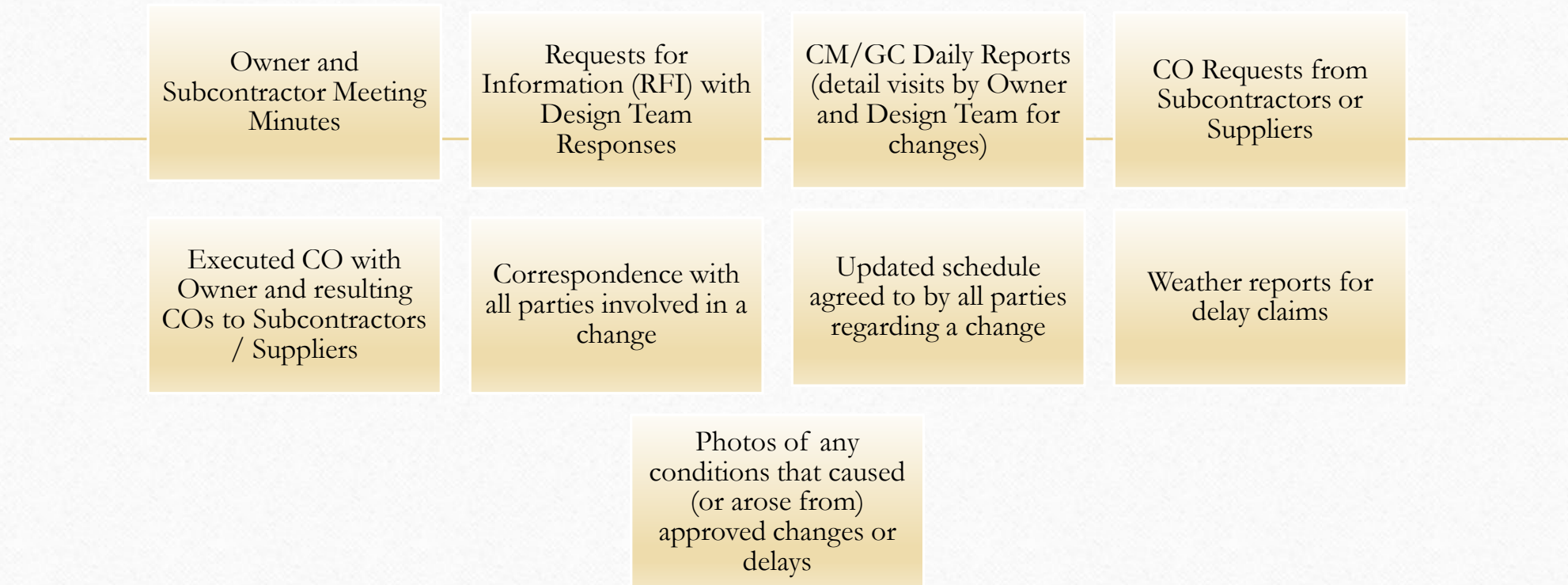
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- Whether hired by an Owner to conduct an audit or by a Contractor to review an audit, our job is to ensure the financial representations made by the Contractor in the accounting records are properly recorded and supported with respect to the expenses attributed to the project.
  - Review of Project Documents:
    - The Forensic Accountant needs to understand how the project was awarded, the contract between the parties involved, the scope of work, schedule, and other deliverables agreed to in the contract in order to evaluate the appropriateness of the Contractor's actions regarding accounting for the work.
  - Review of Accounting Records:
    - All costs / expenses attributed to the project, and subsequently billed to the Owner, should be supported. The supporting documentation should be reviewed and approved by the Contractor on a regular basis, before invoicing the Owner, to ensure that costs are properly captured, approved, reported, and invoiced for payment.

# Records / Documents for Audit

- “In the Normal Course of Business” Documents to be kept by CM/GC (these can / should be utilized to support (or refute) claims made):
  - Contract with Owner
  - Subcontracts
  - Material Contracts
  - Design Documents (Drawings and Specifications along with any updates)
  - Approved Submittals and Shop Drawings from Subcontractors
  - Bills of Lading, Receipts, and Invoices for Equipment and Material Shipments
  - CM/GC Pay Requests to Owner with all appropriate supporting documentation
    - Invoices for reimbursable costs
    - Subcontractor payment applications
    - Approved change orders
  - Daily Reports from CM/GC Superintendent on site
  - Job Cost Reports from CM/GC internal accounting
  - Approved CO Log
  - Progress Photos
  - RFI Log
  - Beginning Project Schedule and all Monthly Updates
  - Closeout Documents required per design documents
    - Warranties
    - Operation & Maintenance (O&M) Instructions
    - As-Built Drawings

# Records / Documents for Audit



**Note: Many of these documents apply to events resulting in a damage claim(s). It is important to document these items in real time, as the event is happening to assist with the litigation process in an effective manner. These documents should enhance those kept in the normal course of business by expanding on how the event in question resulted in the specific claim(s).**

# Case Study - Audit

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## **Builders Risk Insurance Claim Audit**

- School Project – Build New Classroom Building
- As-Builts from School Board were not complete
- Last week of project – turn on irrigation and flood 4 classrooms
- Original Schedule and GMP – Not Met
  - Additional time and costs incurred to repair and / or replace water damage from flood
- Outcome: Insurance paid the claim for additional costs incurred by the CM

# Damage Claims

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## Role of Experts in Determining Damages

# Expert Opinions

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- Different experts opine on different aspects of damage claims:
  - Scope and Quality (engineering expert) - provides an opinion on the quality of work performed, the adequacy of design, and / or the effect of deficient design on the work performed
  - Time (scheduling expert) - assesses the delay caused by an event and determines the responsible party using delay models
  - **Cost (damages expert) - calculates loss utilizing damage models and may rely on the scheduling and engineering experts' opinions to quantify specific elements of damage**
- Often separate reports are produced by each expert, even though there may be overlap in the claims
- Be sure the expert is qualified to testify in the area on which they are opining
  - i.e., a damage expert should not opine on a delay claim unless he / she is also a scheduling expert

# Damage Claim – What’s the Story?

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## Facts and Circumstances

Each case is unique with its own set of facts and circumstances. The type of claim(s) and the facts of the claim(s) will dictate what types of experts, documentation, investigation, and calculations are necessary to quantify the damage claim(s).

Choose the proper expert(s) to opine on the claim(s) at hand. The litigation “damages team” expertise must support the types of claims being asserted.

## Damages Expert

Role is to objectively evaluate the circumstances and supporting documentation to quantify damages. A good starting point is the determination of the costs incurred by the parties involved.

Often must rely on other experts (i.e., engineering and / or scheduling) in the analysis of damages.

Ultimately a claim is made for what the party believes he / she has lost (or incurred) in economic value.

The party’s job is to support the claim and our job is to quantify it.

Our analysis should fit into your client’s story.

# Case Study – Lost Profits Litigation

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## **Construction Defect Litigation**

- Newly Constructed Building housing a Buffet Restaurant – numerous construction defects, including extensive water damage
- Restaurant Owner Sued Construction Company for Breach of Contract
  - failure to deliver the building free from defects and not in conformance with the contract documents
- Oscher hired to quantify damages with respect to lost profits and re-opening costs
  - NOTE: We did not serve as expert for the construction claim, as we are not qualified to opine on that.
- Outcome: Settlement reached before trial enabling restaurant owner to re-build his business

# Case Study – Delay Claim

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## **Owner Caused Construction Delay**

- New Hotel Project - Owner contracts with GC to construct the building and complete the sitework
- FF&E is separate Owner contract with an Interior Design firm
  - Owner does not manage design and delivery of FF&E within the agreed schedule
  - Completion of building delayed due to events within Owner's control
- Scheduling Expert determines Owner caused Delay
- Damages Expert quantifies damages based on additional costs incurred by the GC
  - All costs must be documented, supported, and able to be linked to the additional time required to complete construction
- Outcome: Litigation is avoided as Owner agrees to pay additional costs incurred.

# Conclusion

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What should your Damages (and supporting) Expert(s) bring to your litigation table?

- “Daubert” Proof their analysis:
  - Utilize reliable information that is supportable
  - Construct the damages model using the reliable information in an acceptable form