



Bulletin

Fraud Prevention

INTRODUCTION

Fraud is a common news story. Reports about trusted employees who defraud their employers, leading to severe financial loss or the failure of a business, often become headline-making news.

One definition of occupational fraud is "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." Every company is faced with the potential of fraud. Some are more prepared to manage the risk than others. Some may have processes in place that detect fraud soon after it occurs, while others are unaware of the deception for years and are completely caught off-guard when it comes to light. And, many fraudulent activities go undetected and are never reported.

Fraudulent activities can be committed by a wide range of people, most of whom do not fit a typical criminal profile. These individuals can be employees, subcontractors, suppliers and consultants. It is prudent and fiscally responsible to consider the sources of fraud and establish policies and procedures to prevent its occurrence as much as practically possible.

According to the Association of Certified Fraud Examiners, fraud in the workplace can often be traced back to insufficient internal controls. The most important contributing factors are lack of internal controls (35.5%), override of existing internal controls (19.4%), lack of management review (18.7%), poor ethical tone from the top (9.1%), lack of competent Personnel in oversight roles (7.3%), lack of independent checks/audits (3.3%) or lack of employee fraud education (2.5%).

In 2012, reported cases of fraud in the construction industry occurred in billing (36.2%), Corruption (34.0%), Check tampering (21.3%), non-cash areas (21.3%), payroll (19.1%), cash larceny (17.0%), expense reimbursements (12.8%) and financial statements (8.5%).

What are some examples of fraud and steps that contracting business owners can take to prevent fraud?

INTERNAL JOB COSTING AND ACCOUNTING

- **Project managers (PM) intentionally recording costs to the incorrect job.** For example, the PM may have job A that has encountered difficulties and projected to be below budget, and job B is expected to narrowly meet

original margin estimates. The PM could code an invoice related to job B to job A to make the job appear stronger while “hiding costs” in the job that is already known to be experiencing difficulties. Conversely, costs could be hidden in an over-performing job to make an under-performing job appear closer to target margins.

- **Project managers could hold back expenses** (i.e., hiding invoices in their drawer) to manipulate the timing of the job cost posting and associated revenue recognition. At the same time, accounting personnel could manipulate the timing of expenses to achieve desired financial reporting results (i.e., smoothing revenue recognition).
 - Within construction companies there can exist a risk of **fictitious contracts** to boost the bottom line. This could be evidenced by lack of an executed contract, altered documentation, no change orders, etc.
 - **Risk of losses not being recognized in full on jobs in a loss position.** This exists both as a risk of error and a risk of fraud. Accounting personnel could manipulate the job schedule to hide the loss estimate or intentionally avoid recognizing 100% of estimated losses when losses become more likely than not for a particular contract.
 - **Risk of error and fraud surrounding job estimates** due to the high degree of estimation involved with percentage of completion accounting. As the job schedule at any given date should reflect the expected position for jobs in progress, management attitudes indicative of intentionally deceiving financial statement users through overly conservative estimates or
- overly aggressive estimates might be a sign of fraudulent activity.
- **Check fraud – internal.** Someone in the Accounts Payable (AP) area creates a bogus vendor and invoice and cuts a check payable to that vendor then receives the check and cashes it for personal gain.
 - **Expense Reports** – Turning in expense reimbursements with improper or fictitious supporting documentation.
 - **Project managers manipulating job costs by holding them down at year end** to show a good margin on a job that is actually indicating financial losses for the purpose of receiving a performance bonus. If all the costs were properly accounted for, the job would not show a profit.
 - **Stealing tools** – Make sure that tools and equipment that are purchased for a job stay on the jobsite. Ensure the tools are not shipped to another jobsite or taken home by an employee or subcontractor for personal use.
 - **Ghost employees on the payroll** – A foreman could set up a fictitious employee, record their work time, receive and cash the check with/without the help of a payroll employee.
 - **Diverting lump sum costs to Time and Material projects** – Beware of situations when either your own company or your subcontractor has a lump sum project and a T&M project on the same jobsite. Costs originally attributable to the lump sum project can easily be billed through the T&M project, causing the payer to pay for the work twice.

- **Cash Payments** – Dealing in cash receipts is ripe for fraud. Anyone receiving cash payments for goods or services can easily pocket the money with no trace of payment. The person receiving the cash could pocket it while noting it paid rather than depositing the cash. Make sure that receipts for cash transfer are signed by two parties on the receiving end and that cash is turned over to a third party so that the person receiving the cash is not the same person who applies it. Make sure a paper trail accompanies all internal cash transfers.

EXTERNAL SOURCES

- **Check fraud.** Someone obtains an accounts payable check and is able to “wash” out the name or amount and change the information. For instance, a check made out to Brand X for \$2,000.00 can easily be altered to add in a “0” and it suddenly becomes a \$20,000.00 check.
- An outside party creates a **fictitious company** and submits an invoice to your company payable to the fictitious company, then deposits or takes off with the company funds.
- **Vendor kickbacks.** In certain situations, a vendor can quote a higher price to a contractor employee than the goods or services are worth. When the invoice is paid in full, the vendor makes a “kickback” payment to the employee. To combat this issue, always require competitive bids for all goods and services. Also, periodically review invoices for individual unit prices to make sure they are in line with industry averages.

CONCLUSION

Fraud is preventable, but it takes

proactive steps and constant vigilance. Provide individuals within your company with a means to report fraud and suspicious activity. Make sure that you arrange for independent external audits periodically. On occasion, schedule targeted fraud awareness training for staff. In addition, consider the following measures.

Fraud Prevention Checklist:

- Is ongoing anti-fraud training provided to all employees of the organization?
- Is an effective fraud reporting mechanism in place?
- Are proactive steps taken to detect fraud vs. being reactive to an act only when exposed?
- Is the management climate/tone at the top one of honesty and integrity?
- Are fraud risk assessments performed to proactively identify and mitigate the company’s vulnerabilities to internal and external fraud?
- Does your internal hiring policy include the following (where permitted by law)?
 - ✓ Past employment verification
 - ✓ Criminal background checks
 - ✓ Credit checks
 - ✓ Drug screening
 - ✓ Education verification
 - ✓ References check

Positive Pay – Positive pay systems can be setup between your payroll and AP departments and your local bank. With each check run, the mechanical contractor sends the bank a file with the payee name and amount. When the payee goes to cash the check, it is referenced by the bank against the positive pay list and the bank should only accept the check if it passes the test of the payee name and/or the amount of the check. This prevents check fraud.

Dual Signatures – Make sure that all checks over a certain threshold are signed by two parties, even if one signature is an automatic computer signature. Also require that key documents such as purchase orders, original invoices and receiving reports accompany checks to be signed. This helps prevent unauthorized check disbursements.

Sources:

“The Most Common Types of Construction Fraud,”
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2012 Report to the Nations on Occupational Fraud and Abuse, ©2012, Association of Certified Fraud Examiners, Inc.

“Construction Fraud: How Does it Happen?,” Freley & Driscoll, P.C., Contractor newsletter