

Preventing & Detecting Fraud in Construction Companies

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Categories of Fraud

- Asset Misappropriation
- Corruption
- Fraudulent Statements

Fraud Characteristics

Individuals who are most likely to commit occupational fraud possess similar characteristics.

SAS-99 describes them as:

- Unethical morals
- Financial or lifestyle pressure

Asset Misappropriation

Asset misappropriations involve the theft
or misuse of an organization's assets.

- 90% of asset misappropriation cases involve the theft of an organization's cash such as check disbursements and payroll.
- Cash misappropriation can generally be divided into three categories.

Asset Misappropriation – Technique One

The **first** technique for fraudulent disbursements

involves the disbursement of funds through some trick or device.

Examples of this are:

- Billing Schemes
- Payroll Schemes
- Expense Reimbursement Schemes
- Check Tampering
- Register Disbursements

Asset Misappropriation – Technique Two

The **second** technique is skimming cash from the organization before it has been recorded on the organization's books

This can be done by:

- Unrecorded or Understated Sales
- Lapping Schemes, Write-off Schemes or Concealed Receivables
- Refunds

Asset Misappropriation – Technique Three

The **third** is cash larceny which involves the theft of cash from an organization after it has been recorded on the organization's books

Examples of this are:

- Theft of Cash on Hand
- Theft of Deposits

Corruption

Involves the wrongful use of influence in a business transaction in order to procure some benefit for oneself or another person, contrary to his/her duty to the organization or the rights of another person.

Examples of Corruption are:

- Conflicts of interest involving sales or purchases
- Bribery in bid rigging or invoice kickbacks
- Illegal gratuities
- Economic extortion

Fraudulent Statements

Involves the falsification of an organization's financial statements.

Examples include:

- Improper timing differences
- Fictitious revenues
- Improper asset valuations or measurements
- Concealed or misclassified liabilities and expenses
- Improper disclosures
- Improper ownership
- Falsified employment credentials and other internal or external documents

Fraud and Construction

Construction contractors are certainly not exempt from the shadow of fraud's ability to ruin a successful business.

2004 Report

The top three methods of fraud in Construction were:

1. Check tampering
2. Payroll
3. Skimming

Of the frauds studied, 3.4% of the total fraud was in the construction industry resulting in an average loss of \$145,000

Examples of Fraudulent Disbursements

- Shell Company Example
- Nonaccomplice Vendor Example
- Personal Purchases Example

Shell Company Example

Shell Company Example

- A dishonest employee creates an outside shell (dummy company) from which nonexistent services or materials are being “purchased.”
- The employee submits invoices for his or her company, receives the check, cashes the check, and improperly uses the funds for his or her own purposes

Shell Company Example

Prevention and Detection Methods:

- Establish a vendor approval procedure
- Limit quantity and amounts of disbursements
- Periodically compare addresses of vendors to employees and other vendors
- Obtain supporting documents of significant vendors
- Review endorsements of checks for proper processing
- Be sure bank statements are received by persons not connected with the disbursement process, examine checks for endorsements and alterations, and match statements to checks
- Separate invoice processing and A/P from general ledger and adjusting journal entry functions

Shell Company Example

Prevention and Detection Methods cont...

- Separate P/O's, purchasing, and receiving functions from invoice processing, check issuance, cash receipts, and general ledger functions
- Use software controls to prevent unauthorized access to check issuance and A/P modules
- Reconcile disbursement records to the A/P open invoice file
- Create a policy that all disbursements must be made by check, excluding petty cash
- Use pre-numbered multipart checks and debit / credit memos - periodically verify check sequence
- **Restrict use of manual checks**

Shell Company Example

Prevention and Detection Methods cont...

- Investigate, void, and reissue checks outstanding for a specified time
- Check mathematical accuracy of vendor invoices and compare invoices to P/O and receiving documents
- Stamp all paid invoices

Non Accomplice Vendor Example

An employee changes the address of a vendor (e.g. to a post office box), receives the check, and deposits it in his or her own bank account for cashing. In another method, an employee takes a proper invoice, alters or reissues the invoice for a greater invoice amount, eventually pays the vendor through other means, and pockets the difference.

Prevention and Detection Methods:

- Approve and review vendor file changes, such as addresses. This should be done by a person separate from A/P invoice or check processor
- Match invoices to P/O's, again with the proper segregation of duties

Personal Purchase Example I and II

Example 1:

Employee A purchases materials and supplies for his or her own home improvement project from the local home improvement store, which also does frequent business with the contractor, and charges his or her purchases to the company account.

Example II:

Employee B takes the company truck to the gas station where the contractor has an established charge account and fills up the truck. At the same time he or she carries an extra five gallon gas can and fills it up as well. Later he or she drops off the five gallon gas tank at his/her own vehicle for personal use.

Personal Purchase

Prevention and Detection Methods:

- Review invoices or each register receipt for time of purchase. The purchases should not occur during hours when employees are not working (e.g. Sundays)
- Match purchases with P/O
- Put controls over small purchases, if such purchases are typical and necessary to the particular construction industry specialization
- Match quantities to expected usage such as miles per gallon or miles per tire
- Separate duties – (1) who completes P/O's; (2) who verifies quantities on receipt; (3) who compares dollar amounts and quantities to the estimators' bid work

Payroll Disbursements

Fictitious and Ghost Employee Example:

Payroll clerk employee C sets up a new employee X, or reactivates a terminated employee Y. The payroll clerk then receives the employee's paycheck and cashes the check for personal use.

In another example, a payroll administrator continues to issue paychecks to an employee who quit, but takes them for himself or herself by changing the direct deposit routing to a bank account that he or she controls.

Payroll Disbursement

Prevention and Detection Methods:

- Review rates per hour vs. total hours paid
- Require owner manager approval for all employee additions or changes
- Maintain a daily and weekly count of employees; compare to checks issued.
- Lock up personnel files
- Use direct deposit if possible
- Ensure proper separation of payroll duties
- Conduct periodic surprise hand deliveries of payroll checks by another supervisor or manager
- Compare endorsements on payroll checks

Payroll Disbursement

Prevention and Detection Methods continued . . .

- Compare bank routing numbers to employee names, addresses, and Social Security numbers
- Review new employee Social Security numbers for false number sequences (a list of proper number groupings can be obtained from the S.S. Administration)
- Ensure proper approval of computer employee permanent record changes, including address, bank routing, activations, terminations, and/or name changes

Commission Schemes

Example 1

Salesperson A receives a 4% commission on successful, signed contracts, according to company policy. The company's policy is not based on the profit of the contract but rather only on the gross contract revenue. Salesperson A signs the contract knowing the it will not be profitable in order to collect commission.

Prevention and Detection Methods for Example 1:

The company policy was structured to encourage the production of revenue and not contract gross profit. By paying commission based upon two standards, revenue **and** gross profit, it would encourage employees to negotiate the contracts to be more favorable to the contractor

Commission Schemes

Example 2

Contractor ABC pays a higher commission for new service contracts brought in and a lesser for current service customers that renew their agreements. Salesperson B has a customer that has changed only its name; however, the employee submits the renewal agreement as a new customer in order to receive a higher commission.

Prevention and Detection Methods for Example 2:

There is no profit difference between new and renewed agreements for this particular contractor. The company policy should be changed so that commission is paid equally. This will emphasize the importance of retaining existing customers as well as finding new ones

Commission Scheme

Example 3

Company XYZ pays its project managers an incentive commission or bonus plan based upon the gross profit of a contract as completed. Employee C knows that contract #1 will run over its estimated costs. Employee C improperly job codes the excess costs to contract #2 in hopes that contract #2 will finish better than expected

Prevention and Detection Methods for Example 3:

The employee in this example should also be evaluated on: (1) cash borrowed or flowed from each contract (2) over or under billings on each contract (3) change order approval benchmarking (4) claim avoidance (5) timely paperwork procedures (6) amount of work under management (7) subcontractor administration and other criteria. By using only one criteria, such as budget to actual revenue it makes possible manipulation far more likely.

Commission Scheme – Example 4

Example 4

Company A pays its estimators a commission based on the actual vs. budgeted contract costs. The company specifies that if a project performs better than expected and no estimating errors are found, the estimator receives a commission based on a percentage of the difference of actual vs. budget costs. The estimator always marks up an extra 2% to ensure the bids are under budget and better his/her chances of receiving a commission

Prevention and Detection Methods for Example 4:

As with Example 3, multiple criteria needs to be included when determining commission. In this case the estimator is motivated to overstate the estimates which can result in the loss of close competitive contracts as well as revenue for the company.

Workers Compensation Schemes

By working closely with your workers' compensation insurance company you can see that proper safety policies, procedures, and controls are properly created, modified periodically, and monitored to assure loss avoidance and reduction.

Falsified Wages – Example 1 and 2

Example 1

Employee A obtains the hours report from the other employees and submits these hours to an outside payroll service to have processed. Employee A adds extra hours to her hours worked and has been doing so for 5 years.

Example 2

The office manager, Employee B, has not received a wage increase in a couple of years. Employee B figures that with a weekly payroll and various deductions the owner will notice a slight difference when signing the checks. Employee B gives himself a \$200 raise and offsets it by increasing deductions for federal, state, and credit union withholdings, which result in no weekly change to his paycheck.

Falsified Wages

Prevention and Detection Methods cont...

- Use separate accounts for payroll and deposit only the total of the payroll amount weekly into the account
- Structure internal payroll control – develop a segregation of duties
- Verify wages and hours worked by supervisory personnel
- Review payroll reports, in addition to hours and wages
- Review changes to the employee master file - performed by the supervisory personnel
- Compare the payroll costs to an expected percentage and the amount of payroll tax expense
- Periodically test payroll internal controls
- On a consistent basis perform Benford tests and digit analyses of all payroll disbursements

Diverting Payroll and Withholdings

Example 1

A company is experiencing cash flow difficulties and therefore does not pay the company's appropriate W/H's to a governmental entity and the unions. Fraudulent adjustments to payroll tax expense and union benefit costs are posted to hid the problem. As notices are received from various governmental entities they are collected and hidden. Eventually, one year later their cash accounts are levied by the IRS and the problem becomes known.

Diverting Payroll and Withholdings— Example 2

Example 2

Employee A is the payroll clerk. As amounts are withheld for 401(k) and credit union individual deductions, Employee A slightly increases the reporting in the computer records of his amounts, and slightly reduces several other employee's withholdings. Because Employee A prepares and submits the quarterly reports it is very easy for him to hid his entries.

Diverting Payroll and Withholdings

Prevention and Detection Methods:

- Perform the same prevention methods as used to prevent falsified wages - designate personnel outside the payroll dept. as the entity's contact with taxing authority
- Separate the duty of maintaining check stock custody and check signing
- Use direct deposit whenever possible and any changes to direct deposit must be reviewed
- Reconcile W-2 wages to the general ledger and payroll register wages paid
- Reconcile payroll registers and the general ledger to the gross and net pay amounts per payroll tax returns
- Require employees to sign forms, such as IRS Form W-4, and other supporting documents to verify withholding amounts and rates
- Separate duties of opening mail and completing the general ledger from payroll preparation functions

Expense Reimbursement Schemes

Types of expenses reimbursed / paid by the employer:

- Lodging
- Travel: mileage, airfare, taxi, buses, and other costs
- **Per diems:** an IRS determined average for reimbursement of meals and incidentals. This does not include lodging, since actual support receipts must be used.

Advantages and Disadvantages of Per Diem

Advantages of per diem reimbursements:

- Only need to supply a business purpose for the out of town travel, not detailed receipts
- Employers have a cost ceiling and employees benefit since the excess reimbursement over costs has no tax consequence

Disadvantages of per diem reimbursements:

- They are considered meal expenses and are subject to a 50% disallowance
- Abuse of per diems by employees, employee expectation even without out of town travel
- Equipment rentals
- Meals
- Small tools or expenses

Expense Reimbursement Schemes

Reimbursements can often be altered or fabricated as follows:

Mischaracterized Expenses

Reclassification of a type of expense that is not considered reimbursable

Overstated and False Expenses

Requests are submitted even though overnight travel was done

Multiple Reimbursements

Multiple workers lodge together and take turns paying for the lodging; however, they all submit reimbursement requests

Expense Reimbursement Schemes

Prevention and Detection Methods:

- Increase the hourly or salary paid to cover the reasonable typical travel expense. The disadvantage to this is that the increase in pay is subject to FICA
- Have the employer pay for lodging directly
- Create a non-accountable expense reimbursement where the employee would receive a monthly allowance intended to cover the expenses.

Check Altering Schemes

Check altering schemes can be done by the following processes:

- Forged maker
- Forged endorsement
- Altered payee or maker
- Concealed checks
- Wire transfer
- Credit cards

Check Altering Schemes

Prevention and Detection Methods:

- Secure blank check stocks, both general and payroll
- Segregate and separate duties of check writing and check mailing
- Implement internal controls over disbursements
- Approve and review all bank transfers prior to the actual transfer
- Restrict the authorization of bank transfers and bank line of credit borrowings
- Pre-print limitations regarding check amounts on the checks (i.e., not valid for amounts over \$1,000)
- Emboss checks for the check amounts
- Maintain certain limited amounts in disbursement accounts, especially payroll, with no automatic sweep to cover shortages

Check Altering Schemes

Prevention and Detection Methods cont...

- Make deposits in a separate account than the one checks are written from
- Implement policies regarding credit card usage
- Ask the company manager to record all invoices and checks both mailed and received
- Require original receipts for credit card purchases

Revenue Recognition Fraudulent Schemes

XYZ Electrical contractor performs service work, contract work, and sells supplies from its warehouse. Employee M works behind the counter and “sells” supplies to his friend but voids the transaction and pockets the cash.

Prevention and Detection Methods:

- Collect information of customers of voided sales and call them on a periodic basis
- Require voids or refunds to be approved by a superior
- Use updated software that keeps track of details of sales
- Use pre-numbered forms for sales returns and voids

Cash Theft – Example 1, 2, 3

Example 1

Employee A is in charge of petty cash. Periodically he or she takes in small receipts of personal purchases, puts them in the cash box, and takes the amount in cash.

Example 2

Employee B performs small services and installation contracts that are sometimes paid for in cash. Employee Z works in the office and sometimes pockets the cash and alters or destroys the invoice to hide the theft.

Example 3

Employee N is the bookkeeper and from time to time would make deposits using the slips that say “less cash” and receive cash of \$100 or \$200 and hide it by debiting other expense accounts or miscellaneous income accounts.

Cash Theft Examples

Prevention and Detection Methods:

- Compare in-house copies of deposit slips to actual deposits made
- Rotate duties regarding cash receipts
- Separate duties of preparing, performing, and recording deposits
- Use a bank lockbox for deposits
- Place supervisory personnel over petty cash or eliminate it totally
- Employ proper controls over revenue processes
- Reconcile and replenish petty cash monthly

Cash Skimming

Cash Skimming is the theft of cash before it is recorded in the books and records.

Cash Skimming of Revenue or Sales

- Not fully reporting contracts for cash or checks
- Material sales or equipment rentals for cash
- Change orders performed for cash that are not written up and are collected by employees
- Restoration contracts
- Certain types of specialty contractors

Prevention and Detection Methods:

Similar procedures as cash theft should be used in combination with controls over equipment and material. There should also be the proper separation of controls over revenue and billing systems

Cash Skimming of Accounts Receivable

- The collection of numerous small account receivables by an employee who is also in charge of recording them
- “Lapping” - when numerous small contracts are being done for the same customer and payments are on an ongoing basis
- Outright concealed taking of A/R by an employee
- Collection agency schemes where lack of controls over the collections from a collection agency makes it easy to take proceeds

Cash Skimming of Accounts Receivable

Prevention and Detection Methods:

- Separate persons should open mail and immediately endorse checks with a stamp
- Bond employees who handle cash and receivables
- Separate the duties of collection, depositing, and bookkeeping of receivables
- Periodically match checks received to internal records
- Implement software controls to limit access to journal entries
- Institute a lockbox collection process
- Create internal controls over bad debt write-offs and collection agency administration

Cash Skimming of Refunds and Credits

Example:

Employee A works for ABC Construction, which has significant insurance costs for general liability and workers compensation (which is based on an hourly rate). ABC has been doing business with XZY Insurance company for many years. Unknown to ABC, Employee A is also an owner in XYZ insurance. Employee A has been overstating ABC's expected revenue and labor costs, which dictate how much the insurance will cost for ABC.

By doing this ABC is eligible for a refund from the insurance company. When the underwriters send the refunds back to the insured, they are first sent to XYZ Insurance and then XYZ Insurance sends them to ABC. XYZ Insurance has not been forwarding the checks to ABC and has kept them for themselves.

Cash Skimming of Refunds and Credits

Prevention and Detection Methods:

All vendor relationships have the potential for refunds or credits. A contractor should establish internal controls to properly monitor the collection or crediting of these funds. Also, internal controls over approval of vendor relationships, including not just new relationships, but also continuing relationships, must be put in place.

Inventory and Other Fixed Assets

The misuse and theft of inventory and other fixed assets can occur both externally on the job site as well as internally by employees.

Misuse of Unauthorized Use

Fraud of Inventory and Other Fixed Assets can occur by the following ways:

- The use of company vehicles by employees for personal use
- Personal use of small tools
- Personal use of large equipment
- The taking of valuable scraps

Misuse of Unauthorized Use

Prevention and Detection Methods:

- Only provide vehicles to employees when they are specialty outfitted. If a vehicle is not used for company travel (CFO's vehicle) consider it part of the compensation.
- Consider a non-accountable account arrangement for vehicle usage
- Controls over usage of small tools
- Secure large pieces of equipment overnight and on weekends
- Separate responsibility of identifying scrap from that of disposing of it
- Periodically inspect trash for the inappropriate discarding of valuable materials, scraps, and/or inventory

Theft of Inventory and Other Fixed Assets

Internal theft of inventory needs equal attention as theft by outsiders.

Prevention and Detection Methods:

- Periodically perform Benford testing on inventory
- Secure inventory
- Control use and secure small tools
- Physically secure the job site and business
- Install video cameras around exits and trash dumps
- Attach permanent identification tags to all assets and inventory
- Conduct periodic physical inventory checks of fixed assets
- Review all additions and deletions to asset listings – require

supervisory approval

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Corruption

In construction, corruption can include conflicts of interest, bribery, illegal gifts, and/or extortion

Conflicts of Interest

When an employee gives a discount or takes a higher bid due to some relation or friendship with the customer or vendor.

Prevention and Detection Methods:

- Implement controls and require proper documentation
- Quotes from vendors or subcontractors should be retained to compare
- Install a point of sale system

Bribery

Schemes involving invoice
kickbacks and bid rigging.

Examples of Invoice Kickbacks

Company XYZ purchases a significant amount of vehicles annually from a local car dealership. Employee A, who is in charge of purchasing the vehicles, has made an agreement with the dealership to pay more for the vehicles if he personally gets a kickback or receives a free car after a certain amount of purchased vehicles at the higher price.

Examples of Invoice Kickbacks

Prevention and Detection Methods:

- Rotate major purchasing responsibilities
- Periodically request statements from major vendors
- Implement a company policy prohibiting the acceptance of gifts above certain dollar amounts
- Separate purchasing responsibilities from purchasing requests, shipping, and receiving
- Use competitive bidding practices
- Review purchases to see if the same vendor is winning bids by a specific employee
- Notify vendors of the fraud reporting hotline
- Have someone outside purchasing review estimates, PO's, and purchase prices
- Use pre-numbered PO's and receiving reports
- Verify performance and/or delivery

Financial Statement Manipulation

Involves the overstatement or understatement of assets, liabilities, revenues, or expenses in reports using techniques such as timing differences, fictitious assets, liabilities, or revenues, concealment of assets or revenues, misclassification, improper disclosure, improper measurement or valuation, and improper ownership

Prevention and Detection Methods:

- Annual audits of financial statements
- Completion of risk factors checklist

Employment Credentials

Resumes can significant misstatements such as prior misstatement of claims and history resulting in increased actual injury claims, misstatement of experience and ability, omission of periods of employment or specific employers.

Prevention and Detection Methods:

- Employing an internal human resource director or obtaining consulting from an outside source

Antifraud Measures

1. Employee background checks
2. Anonymous reporting mechanisms (tip hotlines)
3. Internal auditors
4. Independent CPA audits
5. Internal controls

How to Create or Adopt Internal Controls Useful in Fraud Prevention

All businesses have internal controls but must always be evolving them to keep up with the changing business atmosphere and to be suitable for that business.

Risk Factors Checklist

- Inadequate separation or segregation of duties
- Rapid turnover of employees
- Lack of mandatory vacations
- Absentee owner or manager
- Significant portion of employees' compensation dependent on bonuses
- Bonuses for estimators, project managers, purchasing agents, supervisors dependent on specific criteria
- Tax-motivated income or loss goals
- Ownership dispute, potential sale, or divorce circumstance

Risk Factors Checklist

- Owner expectation and demand of income
- Manipulation of contract schedule details
- Failure by owner-management to act on previous management suggestions
- Disregard for authority or regulations
- Continued employment of under-qualified accounting personnel
- Poor reputation in construction industry
- Frequent change in external auditors or CPA's
- Frequent or recent change in banking or bonding

Risk Factors Checklist

- Manipulation of job or contract schedules by CFO or CEO
- Unreasonable demand or time constraints on completion of external audit / tax return
- Restriction on auditor for information or communication
- Failure by owner-manager to provide adequate resources needed by accounting department
- Inability of management to accurately project gross profit in the past
- Presence of OSHA fines and no safety program
- Pressure to meet loan covenants or bonding equity requirements

Risk Factors Checklist

- Construction company is involved in new type of contracts
- Construction company is performing contracts outside geographical area
- Contractor has backlog in excess of prior year's revenue
- Contractor is committed to a contract with a significant penalty provision
- Contractor is involved in projects subject to regulatory restrictions
- Contractor is involved in a contract subject to foreign regulations

Risk Factors Checklist

- Company is experiencing an increase in competition or market saturation
- Company is involved in a tight labor market
- There is a decline in the contractor's industry or specialization
- Cash flow difficulties
- Interest rates on current debts are higher than the industry average
- Significant underbillings where overbillings are expected
- No cash increase when company reports earnings or income growth
- Significant job borrowing and individual job profit fade

Risk Factors Checklist

- Recent contributions to owner's equity
- No dividend paying history
- Extraordinary usage of capital and operating leases
- Problem in obtaining bonding capacity
- Significant claims or unapproved change orders
- Overly complex organizational structure
- High vulnerability to changes in interest rates
- Threat of bankruptcy, foreclosure, or repossessions
- Participation in tax shelter schemes
- Unusually rapid growth, profitability, or gross profit
- Decline of proposed purchase, sale, merger, bonding, lending agreement if certain minimal financial results are not achieved

Risk Factors Checklist

- Contractor that collects or uses significant amounts of physical cash
- Contractor with large inventories of materials, supplies or small tools
- Lack of owner or management oversight
- Lack of potential employee screening procedures
- Inadequate recordkeeping over significant company procedures and areas
- Lack of appropriate procedures for authorizing and approving transactions
- Lack of appropriate documentation

Fraud Prevention Techniques

- Creation of an ethical culture from management and ownership down
- Documented and tested internal controls
- Monitoring and responding to pressure on employees to commit fraud
- Implementation and communication of company policies
- Periodic job rotation and mandatory vacation policies
- Implementation of physical safeguards
- Considering use of surveillance procedures
- Preparation of timely, detailed, and comparative financial statements
- Implementation of an employee or company hotline system for reporting suspected fraud

Fraud Prevention Techniques continued . . .

- Periodic performance reviews
- Implementation of independent verifications
- Proper segregation and separation of duties
- Annual independent financial audit
- Verification of limitation of computer access and authorization controls
- Dual signatures on checks
- Physical controls over company documents and records