Construction Industry Fraud - “What is it and how do you prevent it?”

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Brown, Edwards & Company, LLP
Brown Edwards – Firm Information

Firm Information:

- Approximately $50+M in annual revenue
- 400+ Team Members
- Top 100 Accounting Firms in the Country – Inside Public Accounting (#95)
- Named One of the Top-Four Most Successful Firms in the Country – Accounting Today – April 2019
- Largest Non-National, Independent Firm in the State of Virginia – Virginia Business Magazine
- Recently Acquired the Roanoke and Newport News Practice of DHG, the Roanoke and Lynchburg Practice of CBH, and Yancey Bowman in Harrisonburg
- Member of the BDO Alliance (access to National and International Resources)
Brown Edwards – Construction Practice

Practice Information:
- 25,000 hours spent annually serving this practice by 40+ team members
- Recently Named a Top 50 Construction Accounting Firm in the Country – Construction Executive Magazine
- 9 Certified Construction Industry Finance Professionals (CCIFP)
- Services:
  - Sophisticated Tax Consulting and Planning (179D, R&D, Capital Investment, Incentive Comp.)
  - FAR Audits and Overhead Rate Enhancement
  - Project Costing/Bidding and Pricing Strategies/Cash Flow Planning
  - Bonding and Prequalification Support and Capacity Enhancement
  - Cybersecurity Consulting
  - Litigation Claim Support
  - Multi State and Local Taxation Assistance
  - EBP Planning and Administration
  - Valuations, Succession and Estate Planning, Wealth Management
Fraud by the Numbers

Fraud Statistics:

- 83% of construction executives report their company was a victim of fraud in the past 12 months
- 86% of construction executives report their company experienced a cyber incident or information/data theft, loss or attack in the past 12 months
- 34% of construction executives reported losses of 7% or more of company revenues from fraud incidents in an industry with increasingly tight margins
- Construction industry second highest fraud rate of all industries (behind retail)
- The construction industry generates the most DOJ corruption cases

• Source: Kroll Global Fraud Report
Fraud by the Numbers

Percentage of construction, engineering and infrastructure companies affected by different types of fraud:

- Theft of physical assets – 36%
- Vendor, supplier or procurement fraud – 24%
- Regulatory or compliance breach – 18%
- Internal financial fraud – 11%
- Corruption and bribery – 11%
- Information theft – 9%
- Management conflict of interest – 9%
- Intellectual property theft – 7%
- Money laundering – 4%
- Market collusion (price fixing) – 4%
- Misappropriation of company funds – 1%

Source: Kroll Global Fraud Report
Fraud by the Numbers

2018 Report to the Nations

- 50% of corruption cases were detected by a tip
- Internal control weaknesses were responsible for nearly half of frauds
- Losses are far greater when fraudsters collude
- $7+ Billion in total losses
- $130,000 median loss per case
- 22% of cases causes losses of $1M+
- Organizations with hotlines detect fraud tips more often –
  - 46% (hotlines) vs. 30% (no hotlines)
- Small businesses lost almost twice as much per scheme to fraud
  - >100 employees – median loss - $104,000
  - <100 employees – median loss - $200,000
- Losses caused by men were 75% larger than losses caused by women
- A majority of the victims RECOVERED NOTHING

Association of Certified Fraud Examiners
Fraud by the Numbers

- 2018 Report to the Nations
  - Asset misappropriation schemes present the greatest risk because they generally don’t require collusion if internal controls are weak.
  - Median Loss and Percent of Cases
    - Check and payment tampering - $150,000 – 12%
    - Billing - $100,000 – 20%
    - Noncash - $98,000 – 21%
    - Cash Larceny - $75,000 – 11%
    - Payroll $63,000 – 7%
    - Skimming - $50,000 – 11%
    - Expenses reimbursements - $31,000 – 14%
    - Register disbursements - $29,000 – 3%
    - Cash on hand - $20,000 – 15%
Fraud by the Numbers

- How is Fraud Generally Detected?
  - Tip – 39.1%
  - Internal Audit – 16.5%
  - Management Review – 13.4%
  - By Accident – 5.6%
  - Account Reconciliation – 5.5%
  - Other – 5.5%
  - Document Examination – 3.8%
  - **External Audit** – 3.8%
  - Notified by Law Enforcement – 2.4%
  - Surveillance/Monitoring – 1.9%
  - IT Controls – 1.3%
  - Confession – 1.3%
Fraud by the Headlines

- “State Contractor Sentenced To 18 Months In Federal Prison Following Conviction For Mail And Wire Fraud In Connection With State-Run And Federally Funded Bridge Maintenance Project” - JD Supra
  - “ACME was required to purchase a specific chemical sealer and to submit documentary proof to the NYSDOT of the kind and amount of approved sealer used. Lorenz was charged and convicted for purchasing less than the amount of materials required under ACME’s contracts with the NYSDOT, and then submitting fraudulent invoices from a shell company to the NYSDOT which purported to show that ACME was in fact purchasing the appropriate amount of materials.”

- “Former Airport Official Convicted in Record Setting Bribe and Kickback Scheme” - DOJ
  - “In one scheme, Warner drafted and submitted fraudulently-inflated invoices for work which co-defendant William Pritula, 69, of Romulus, was contracted to perform at the airport. Upon payment by the WCAA to Pritula, Pritula would kickback roughly half of the profits to Warner—a total of over $5 million over four years—the largest bribe prosecuted to date in the Eastern District of Michigan.”
  - “In another scheme, Warner drafted and submitted fraudulent invoices on behalf of co-defendant Douglas Earles, 60, of White Lake, the owner and operator of North Star Plumbing. In the invoices Warner wrote, he billed the airport for industrial-sized plumbing fixtures which Earles never installed. In exchange, Earles would kickback roughly 40 percent of the profits to Warner—over $100,000 between June of 2010, and August of 2013.”
**Fraud by the Headlines**

- **“Anti-Kickback Act Settlement Costs Contractor $2.72 Million” –**
  
  "...in Sevenson’s case, the government alleged that the contractor violated the Anti-Kickback Act by soliciting and accepting kickbacks from six subcontractors, which were then awarded subcontracts to perform work under Sevenson’s EPA prime contract. Sevenson allegedly compounded its legal problems by passing the majority of these kickbacks through to the EPA, resulting in False Claims Act charges."

- **“Manhattan U.S. Attorney Files Fraud Suit Against Three Painting Contractors for Lying About Disadvantaged Business Participation on Federal Projects” – NYC Government**
  
  "...the defendants made it appear that TOWER, a certified disadvantaged business enterprise, was executing millions of dollars of steel painting work at the Brooklyn Bridge and the Queens Plaza transit line when in fact much of the work was performed by SPECTRUM, a non-DBE. In return for being included in the projects, SPECTRUM paid kickbacks to AHERN in the form of a $10,000 “commission payment” and a free trip to Atlantic City. By repeatedly submitting false statements to the New York City Department of Transportation ("NYC-DOT") mischaracterizing Tower's work at these projects, the defendants received millions of dollars in federal funds to which they were not entitled."
“New York contractor lost $4B of contracts in wake of bribery, bid-rigging allegations.” – Construction Dive

- LPCiminelli executives were charged in 2016 with allegedly paying bribes to state officials in order to win the construction contract for the $750 million Tesla solar panel factory in Buffalo, New York. As rumors began to surface in 2015 about an investigation into the company, LPCiminelli immediately lost almost $1 billion in contracts, which increased to a total of $3.9 billion. “

- "Since the indictments, LPCiminelli, which appeared on ENR's 2016 Top 400 Contractors list, has auctioned off its equipment and tools and laid off 10% of its workforce..."

“Former VA Contractor Official Took Over $2.5 Million In Kickbacks” – DisabledVeterans.org

- "Patel's crime involved a sweeping fraud that harmed many federal agencies and the American citizens and government employees who depend upon them," Vermont’s United States Attorney Christina Nolan said in a statement issued after the court appearance.

- "Investigators learned of the fraudulent activity while investigating bidding patterns at the VA medical center located in White River Junction, Vermont. Patel allegedly falsified a bid as a part of his duties for his employer Schneider Electric Buildings America Inc. that was detected by investigators."
Fraud by the Headlines

“Turner Construction, Bloomberg LP execs face bribery, bid-rigging charges” – Construction Dive

- "Manhattan District Attorney Cyrus Vance announced Tuesday the indictments of former Bloomberg LP and Turner Construction Co. executives, as well as subcontractors and vendors, on charges of conspiracy, bribery, bid-rigging and other offenses after they allegedly tried to steal approximately $15 million from Bloomberg during a major renovation of the financial media giant's New York City offices."
- "Vance said "inside information" about the Bloomberg project was given to subcontractors in order to help them win contracts for the job. The defendants, he said, inflated their budgets with fake invoices and purchase orders and even filed phony applications for women-owned business status. Subcontractors allegedly gave the former Bloomberg and Turner executives cash and other incentives like vacations and free home renovations in exchange for their lucrative contracts."

“FBI investigating MGT Construction accounting scheme” – Richmond Biz Sense

- “The inquiry, which could lead to potential criminal charges, is said to be centered on a scam that shifted expenses across various MGT construction jobs in order to hide losses, inflate profits and boost bonuses of three main MGT employees from 2013 to 2016.”
- “Thalhimer has said in court filings that the scheme resulted in losses upwards of $30 million. The financial blow was so fierce, filings state, that the company was forced to borrow $4 million from several of its top executives for a cash infusion or "the company may not have survived."
Fraud by the Headlines

“IN project manager charged in $3M embezzlement scheme” – Construction Dive

- Prosecutors claim that 52-year-old Troy Sissom created a sham company in 2003 and submitted fake material invoices to F.A. Wilhelm Construction for jobs he supervised. According to the Indianapolis Business Journal, Wilhelm is the second-largest contractor in Indianapolis, and Sissom was a project manager and worked with clients such as the University of Indianapolis and Eli Lilly.
- Prosecutors said Sissom plans to plead guilty and faces up to 20 years in prison. He must also make restitution to Wilhelm, as well to the Internal Revenue Service in the amount of $381,000.

“Bookkeeper charged with embezzling $6.9 million from construction company” – The Press Democrat

- A bookkeeper for a construction materials company embezzled $6.9 million and used the money to go on a shopping spree that included a 104-acre ranch and a half-dozen talking trees like those in "The Wizard of Oz," federal authorities said Monday.
- Prosecutors say Angela Buckborough Platt also bought eight show horses; a fleet of motor vehicles including a 1964 Ford Thunderbird; a house on five acres in Rhode Island; Hollywood-grade cinematic props to decorate her home for Halloween; and a life-size ceramic statue of Al Capone.
- Authorities say that in June 2000, Platt began to write checks from company accounts to herself. The weekly deposits initially ranged from $2,000 to $5,000 but eventually neared $50,000, prosecutors said. Her theft was discovered in June by another bookkeeper who had been newly hired to assist her.”
Why is the industry more vulnerable?

- Driven by economic pressures.
- Location driven suppliers, and subcontractors.
- Field job management and decision making resulting in reduced oversight.
- Long project life-cycle’s largely based on budgeted amounts.
- Negotiation process with multiple potential customers, suppliers and subcontractors.
- Large dollar volumes and transactions.
- Quid-pro-quo mentalities.
- Focus on obtaining and managing work but not on the financial details.
- Misplaced trust in long-term employees.
- Poor internal controls.
What is the fraud triangle?

- **Point 1 – Pressure on the individual** – personal financial pressure, debt problems, unmet expectations or poor performance.
- **Point 2 – Opportunity to commit fraud** – the stage in which someone sees a clear course of action to relieve the pressure which they believe is unlikely to be discovered.
- **Point 3 – Ability to rationalize fraud** – they are able to justify it in a way that is acceptable to their internal more compass and not feel they are doing anything wrong.

*Leadership should be aware of these potential indicators with employees*
Breakdown of the fraud triangle points

- **Point 1 – Pressure**
  - Living beyond their means
  - High personal debt
  - Excessive gambling habits
  - Drug/Alcohol/Other addictions
  - Undue family or peer pressure

- **Point 2 - Opportunity**
  - Placing too much trust in key employees
  - Lack of proper procedures for authorization of transactions
  - No separation of authorization of transactions from the custody of assets
  - Close association with customers/vendors

- **Point 3 – Rationalization**
  - Overwhelming desire for personal gain
  - Feeling that pay is not commensurate with responsibility
  - Strong challenge to “beat the system”
  - Feeling that business owners, family members or key executives are benefitting unfairly from their effort and contribution
What are some of the most common frauds?

- **Falsifying payment applications**
  - Erroneous totals or line items
  - Roll-forward errors
  - False invoices
  - Inflated rates
  - Personal expenses

- **Billing for unperformed work**
  - Overstate units of labor or equipment actually used
  - Falsifying rates by type of employee used
  - Changes in scope not modified by change orders
  - Billing for premium products when subpar products are used
What are some of the most common frauds?

- **Subcontractor/Supplier collusion**
  - Bid-rigging
  - Price fixing
  - Bid rotation
  - Bribes and kickbacks
  - False or inflated change orders
  - Undervalued deductive change orders
  - Phantom subcontractors/supplier

- **Manipulating change orders**
  - Change orders for in-scope work
  - Missing scope descriptions
  - Excess charges or units
  - Omission of design specifications in the original scope of work
  - Improper price reduction for work substitution
What are some of the most common frauds?

- Manipulating the schedule of values and contingency accounts
  - Failing to update the SOV as buyouts or changes are made
  - Leaving room to charge phony bills received from shell companies
  - Hides ability to spot by budget to actual performance
  - Also done by subcontractors for materials or supplies billed on a pass-through basis

- Fraudulent payments by accounting personnel
  - Payments to fictitious vendors and/or employees
  - Payment of a valid invoice twice and changing the payee on the actual check but not in the system
  - Fraudulent electronic fund transfers
  - Writing a manual check to an improper payee while recording it in the system to a valid vendor
  - Changing pay rates without approval
What are some of the most common frauds?

- Theft of company assets
  - Job-site material theft
  - Utilization of company equipment for personal use and side-work
  - Purchase and intercepting of excess materials
  - Theft of small tools
  - Utilization of company credit cards for personal use
  - Fuel theft
  - Inflated time cards
  - Unauthorized scrap/unused material sales

- Others:
  - Intentional misquoting of project costs
  - Misapplication of valid job costs to better performing or newer jobs to hide performance issues
  - Manipulation of estimated costs to complete to enhance profitability recognition and performance bonuses
  - Disadvantage business fraud
  - Quality control testing misrepresentation
  - Conflicts of interest
What are steps you can take to deter or detect fraud?

- **Tone at the Top**
  - Lead by example – have a strong work ethic and make sure you model the behavior that you want your employees to conduct themselves
  - Consistency – do what you said you would do, under promise and over deliver, don’t play favorites
  - Set a standard of integrity – Compliance with laws and regulations, fair treatment of customers and suppliers, ethical business practices
  - Accountability – hold everyone accountable to policies and procedures including employees, suppliers and subcontractors

- **Hiring/Termination Practices**
  - Perform background checks for positions of trust
  - Conduct previous employer reference calls
  - Make sure that new employees are trained on your processes and procedures
  - Discipline and terminate employees where necessary, no matter the person or position
  - Make sure that your employees treat others with respect
  - Follow your gut!
What are steps you can take to detect or deter fraud?

- **Payroll fraud**
  - Use a GPS linked time card system
  - Mandate use of direct deposit or pay cards
  - Knowledgeable employee should review payroll register for indications of changes in pay rates, terminated employees still on payroll, unapproved bonuses
  - Restrict ability to change pay rates to HR department

- **Vendor/Supplier/Subcontractor fraud**
  - Conduct a thorough background screening before working with anyone
  - Always review invoices, pay applications and wage rates
  - Review itemized payment applications
  - Monitor compliance with contract specifications for work performed/material
  - Obtain written documentation regarding claims
  - Use a qualified pool of subcontractors/suppliers
  - Comfort/Trust = “increased risk”
What are steps you can take to detect or deter fraud?

**Bid rigging**
- Include non-collusion affidavits as a bid document requirement
- Perform a solid pre-qualification process
- Be aware of potential indicators:
  - Bids from multiple companies that look similar or may contain similar mistakes
  - A group of bids that are way above internal estimates
  - Look for indications of physical alterations on bids that could be done at the last minute
  - Qualified bidders you expected to bid that do not bid
  - Prices mysteriously drop when there is a new competitor

**Contract oversight**
- Establish strict project controls and adherence to the contract
- Maintain adequate oversight throughout the construction process
- Understand the scope of work and make sure it is broken down into a trackable schedule of values
- Understand what audit rights in the contract are and utilize them if any suspicions arise (or randomly to be fair to all vendors)
What are steps you can take to detect or deter fraud?

- **Kickbacks/Bribery**
  - Periodically review vendor transactions for unusual concentrations with a few vendors or specific vendors tied to specific estimators or project managers
  - Have a procurement policy that includes limited procedures for lower-dollar thresholds. Research and verify the following:
    - Ownership and EIN
    - Physical address and valid phone numbers
    - Website presence
  - Periodically compare employee addresses to vendor addresses
  - Create a robust vendor set-up process that is approved by someone outside of the procurer
  - Establish and enforce a written bid policy with detailed procedures and defined roles and responsibilities
  - A formal bribery and kickback assessment
What are steps you can take to detect or deter fraud?

**Internal fraud**
- An owner or management should monthly or at least randomly:
  - Receive all bank statements unopened and review the statement for unusual items
  - Review cancelled checks
  - Review payroll reports
  - Review credit card statements
  - Review invoice supporting documentation with check runs or ETF reports
- Prepare and review financial statements on a regular basis
- Monitor your jobs-in-progress schedule monthly
- Require dual signatures on checks over an established amount
- Ask questions so people know that you are looking

**Internal fraud, continued**
- Segregate job duties
- Have someone perform job functions when someone is away from the office
- Require mandatory vacations for all key personnel
- Implement a whistleblower tip line
- Require wire transfers be authorized by an owner or member of management
- Reconcile billings with general ledgers monthly
- Compare cash receipts to accounts receivable
- Review all credit memos or invoice write-offs
What do you do if fraud is suspected/identified?

- Contact legal counsel
- Contact CPA
- Possibly engage a Certified Fraud Examiner to oversee an investigation
- Contact local authorities (most don’t)
- Notify your client if required in your contract
- Move cautiously through the process
- Try to not overreact
- Set an example of the fraudster once all facts are known
Thank you!

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