



ATCHLEY & ASSOCIATES<sup>LLP</sup>  
CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

# FRAUD IN THE CONSTRUCTION INDUSTRY

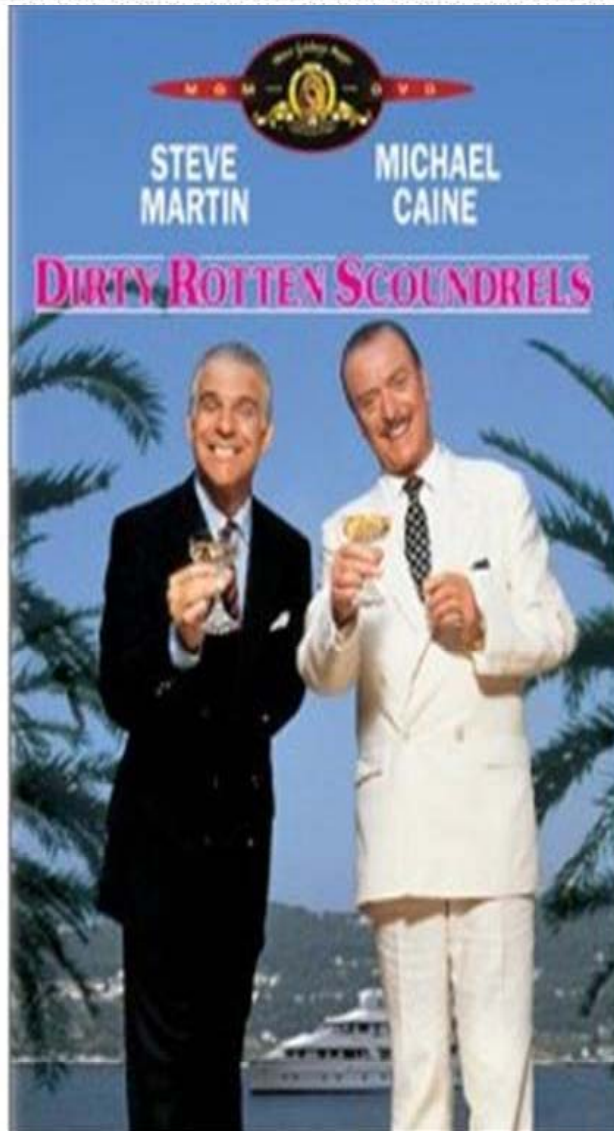
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# OBJECTIVES

1. What is fraud and why should we care?
2. Who commits fraud and why?
3. Most common types of fraud in construction.
4. Overview of some proactive and remedial measures to prevent fraudulent behavior, detect problems early, and minimize impact of fraud within an organization?

# I. DEFINITION OF FRAUD

- A. Illegal act characterized by deceit, concealment or violation of trust
- B. Occupational fraud – fraud in the workplace
  - i. Story of a merchant
  - ii. True or False – Everyone is susceptible to fraud
  - iii. True or False – A typical organization loses 5% of gross revenue in a given year as a result of fraud

## II. WHO COMMITS FRAUD AND WHY

### A. Who

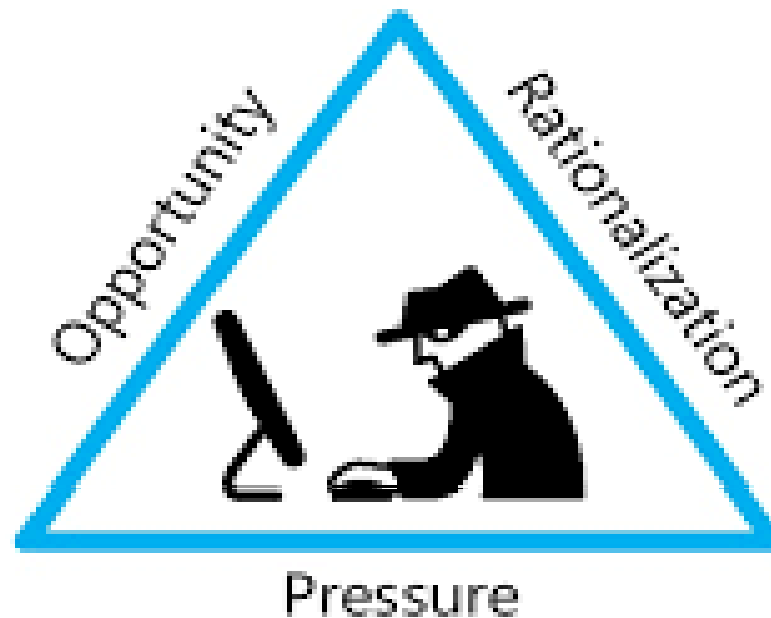
- i. True or False – Most fraudsters are first-time offenders.
- ii. Employees, Subcontractors, Suppliers
  - 1. Contract manager who provided winning bid information to friends and then arranges change orders to make up for losses
  - 2. Employee colluding with a vendor or subcontractor to pay invoices for fictitious work while taking kickbacks
  - 3. Subcontractor billing for journeyman when the work is done by an apprentice

## II. WHO COMMITS FRAUD AND WHY (cont...)

### B. Why

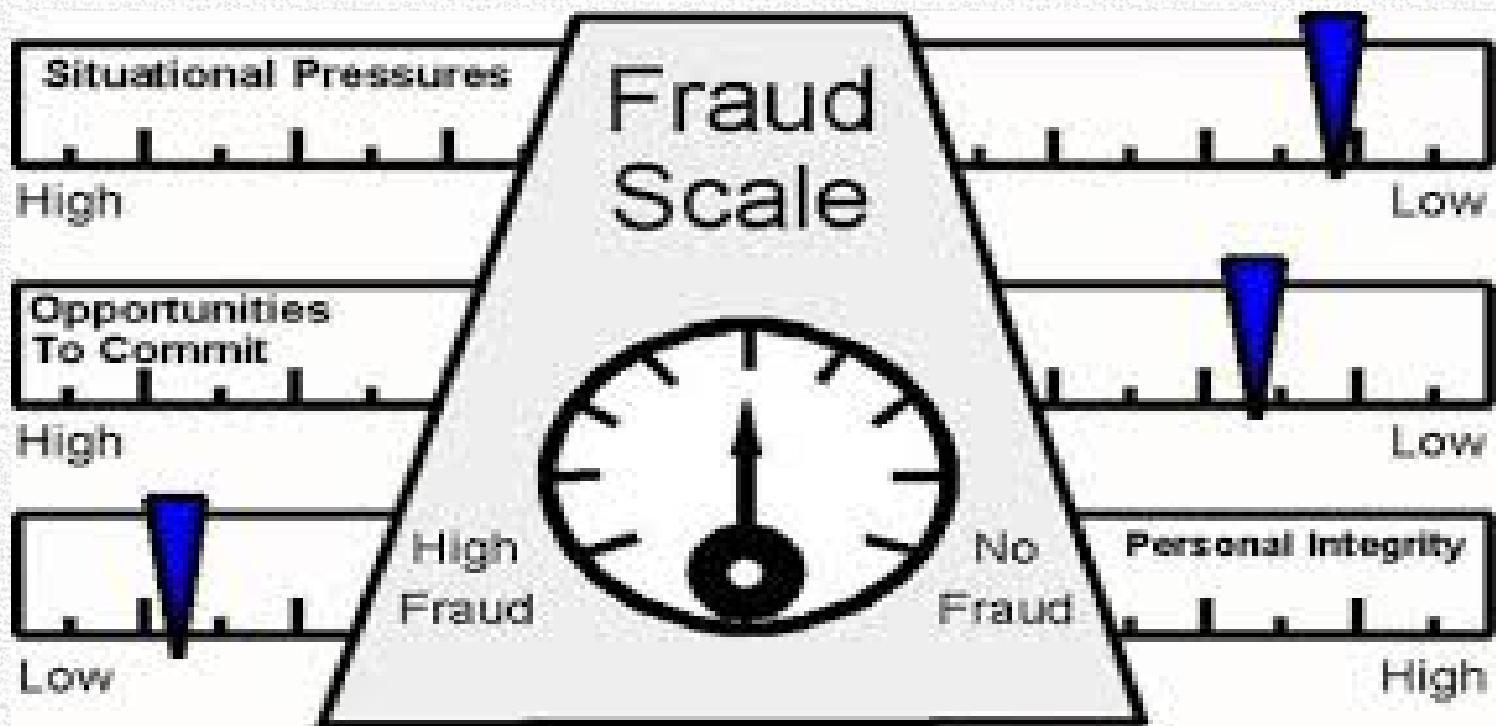
#### i. Cressey's Fraud Triangle

# Fraud Triangle



## II. WHO COMMITS FRAUD AND WHY (cont...)

### i. Albrecht's Fraud Scale



Albrecht, Howe, Ramsey. "Detecting Fraud: The Internal Auditor's Perspective," p6

### ii. MICE - Money Ideology Coercion Ego

## TRUE OR FALSE

True or False –

*In a survey conducted in 2015, 75% of construction companies reported fraud occurring within the last year.*

True or False –

*In 2015, the construction industry accounted for less than 4% of fraud cases.*

True or False –

*When fraud occurs in the construction industry, the median loss is greater than the average loss of all industries*

# III. MOST COMMON TYPES OF FRAUD IN CONSTRUCTION

- A. False Payment Applications – makes up 50% of construction fraud
  - i. Sample invoice

COMPANY NAME

123 Main Street  
Ocean View, TX 12345  
CustomerService@TailSpinToys.com  
www.tailspintoys.com  
P: 123-555-0123  
F: 123-555-0124

INVOICE

Invoice No.: 1001  
Invoice Date: DATE  
Due Date: DATE

**BILL TO:**  
Hany Morcos  
Fourth Coffee  
123 Main Street  
Appleville, KY 12345  
123-555-1234

**SHIP TO:**  
Hany Morcos  
Fourth Coffee  
123 Main Street  
Appleville, KY 12345  
123-555-1234

DESCRIPTION		AMOUNT
Item 1	QTY 20 @ \$500 each	\$10,000.00
Item 2	QTY 12 @ \$450 each	\$6,400.00
SHIPPING		\$0.00
TOTAL		\$17,400.00

Make all checks payable to COMPANY NAME

Thank you for your business!

### III. MOST COMMON TYPES OF FRAUD IN CONSTRUCTION (cont...)

- i. Erroneous totals, line items, roll-forward errors, false invoices, inflated rates
- ii. Project managers falsifying pay applications to cover up personal expenses
- iii. Employee funneling money to false companies they control

### III. MOST COMMON TYPES OF FRAUD IN CONSTRUCTION (cont...)

#### B. Billing Fraud

- i. Overstate unit of productivity (labor hours, etc.)
- ii. Billing for journeyman when apprentice did work
- iii. Inflated equipment rates or billing for equipment used on other jobs

#### C. Manipulation of Change Orders

- i. Missing scope descriptions
- ii. Excess charges
- iii. Omission of design specs

#### D. Theft or Substitution of Materials

- i. Subs/Suppliers
- ii. Employees

## IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD

### A. Organizational Policy and Culture

- i. Ethics Policy
- ii. Hotline/reporting procedures
- iii. Internal Ethics Training

## Sample Fraud Policy

<b>Background</b>	The corporate fraud policy is established to facilitate the development of controls that will aid in the detection and prevention of fraud against ABC Corporation. It is the intent of ABC Corporation to promote consistent organizational behavior by providing guidelines and assigning responsibility for the development of controls and conduct of investigations.
<b>Scope of Policy</b>	<p>This policy applies to any irregularity, or suspected irregularity, involving employees as well as shareholders, consultants, vendors, contractors, outside agencies doing business with employees of such agencies, and/or any other parties with a business relationship with ABC Corporation (also called the Company).</p> <p>Any investigative activity required will be conducted without regard to the suspected wrongdoer's length of service, position/title, or relationship to the Company.</p>
<b>Policy</b>	<p>Management is responsible for the detection and prevention of fraud, misappropriations, and other irregularities. Fraud is defined as the intentional, false representation, or concealment of a material fact for the purpose of inducing another to act upon it to his or her injury. Each member of the management team will be familiar with the types of improprieties that might occur within his or her area of responsibility, and be alert for any indication of irregularity.</p> <p>Any irregularity that is detected or suspected must be reported immediately to the Director of _____, who coordinates all investigations with the Legal Department and other affected areas, both internal and external.</p>
<b>Actions Constituting Fraud</b>	<p>The terms defalcation, misappropriation, and other fiscal irregularities refer to, but are not limited to</p> <ul style="list-style-type: none"> <li>Any dishonest or fraudulent act.</li> <li>Misappropriation of funds, securities, supplies, or other assets.</li> <li>Impropriety in the handling or reporting of money or financial transactions.</li> <li>Profiteering as a result of insider knowledge of company activities.</li> <li>Disclosing confidential and proprietary information to outside parties.</li> <li>Disclosing to other persons securities activities engaged in or contemplated by the company.</li> <li>Accepting or seeking anything of material value from contractors, vendors, or persons providing services/materials to the Company. Exception: Gifts less than \$50 in value.</li> <li>Destruction, removal, or inappropriate use of records, furniture, fixtures, and equipment; and/or</li> <li>Any similar or related irregularity.</li> </ul>

<b>Other Irregularities</b>	<p><i>Irregularities</i> concerning an employee's moral, ethical, or behavioral conduct should be resolved by departmental management and the Employee Relations Unit of Human Resources rather than the _____ Unit.</p> <p>If there is any question as to whether an action constitutes fraud, contact the Director of _____ for guidance.</p>
<b>Investigation Responsibilities</b>	<p>The _____ Unit has the primary responsibility for the investigation of all suspected fraudulent acts as defined in the policy. If the investigation substantiates that fraudulent activities have occurred, the _____ Unit will issue reports to appropriate designated personnel and, if appropriate, to the Board of Directors through the Audit Committee.</p> <p>Decisions to prosecute or refer the examination results to the appropriate law enforcement and/or regulatory agencies for independent investigation will be made in conjunction with legal counsel and senior management, as will final decisions on disposition of the case.</p>
<b>Confidentiality</b>	<p>The _____ Unit treats all information received confidentially. Any employee who suspects dishonest or fraudulent activity will notify the _____ Unit immediately, and <i>should not attempt to personally conduct investigations or interviews/interrogations</i> related to any suspected fraudulent act (see <b>Reporting Procedure</b> section below).</p> <p>Investigation results <i>will not be disclosed or discussed</i> with anyone other than those who have a legitimate need to know. This is important in order to avoid damaging the reputations of persons suspected but subsequently found innocent of wrongful conduct and to protect the Company from potential civil liability.</p>
<b>Authorization for Investigating Suspected Fraud</b>	<p>Members of the Investigation Unit will have</p> <ul style="list-style-type: none"> <li>• Free and unrestricted access to all Company records and premises, whether owned or rented; and</li> <li>• The authority to examine, copy, and/or remove all or any portion of the contents of files, desks, cabinets, and other storage facilities on the premises without prior knowledge or consent of any individual who might use or have custody of any such items or facilities when it is within the scope of their investigation.</li> </ul>

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**Reporting Procedures**

Great care must be taken in the investigation of suspected improprieties or irregularities so as to avoid mistaken accusations or alerting suspected individuals that an investigation is under way.

An employee who discovers or suspects fraudulent activity will *contact the \_\_\_\_\_ Unit immediately*. The employee or other complainant may remain anonymous. All inquiries concerning the activity under investigation from the suspected individual, his or her attorney or representative, or any other inquirer should be directed to the Investigations Unit or the Legal Department. No information concerning the status of an investigation will be given out. The proper response to any inquiries is, "I am not at liberty to discuss this matter." *Under no circumstances* should any reference be made to "the allegation," "the crime," "the fraud," "the forgery," "the misappropriation," or any other specific reference.

The reporting individual should be informed of the following:

- Do not contact the suspected individual in an effort to determine facts or demand restitution.
- Do not discuss the case, facts, suspicions, or allegations with *anyone* unless specifically asked to do so by the Legal Department or \_\_\_\_\_ Unit.

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**Termination**

If an investigation results in a recommendation to terminate an individual, the recommendation will be reviewed for approval by the designated representatives from Human Resources and the Legal Department and, if necessary, by outside counsel, before any such action is taken. The \_\_\_\_\_ Unit does not have the authority to terminate an employee. The decision to terminate an employee is made by the employee's management. Should the \_\_\_\_\_ Unit believe the management decision inappropriate for the facts presented, the facts will be presented to executive level management for a decision.

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**Administration**

The Director of \_\_\_\_\_ is responsible for the administration, revision, interpretation, and application of this policy. The policy will be reviewed annually and revised as needed.

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**Approval**

\_\_\_\_\_  
(CEO/Senior Vice President/Executive                      Date

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## IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD (cont...)

### A. Audits

- i. Traditional Audit or Review
- ii. Construction Audit
- iii. Operational Audit or Process Review

## IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD (cont...)

### C. Internal Controls/Procedures

#### i. Separation of Duties

##### 1. Cash/Bank

- a. Segregate receipt, accounting record posting, bank reconciliations
- b. Two signatures on checks
- c. Review front and back of cancelled checks

##### 2. Accounts Payable – separate set-up of vendors, approval of payments, and actual payments

##### 3. Payroll – separate set-up, approval, and pay

##### 4. Sub selection process

## IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD (cont...)

### C. Internal Controls/Procedures (cont...)

#### ii. Trust but Verify

1. Inventory and secure job site materials and equipment
2. Conduct supplier confirmations
3. Tie subcontractor bills to payment applications
4. Reconcile payments to pay applications
5. Conduct account receivable confirmations
6. Change order review
  - a. Compare change order signature dates to actual time work completed
  - b. Compare drawing/spec volumes to actual claimed

## IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD (cont...)

### C. Internal Controls/Procedures (cont...)

#### ii. Trust but Verify (cont...)

7. Compare actual to budget on a line-by-line basis
8. Invoice spot checks
9. Data mine employee statistics (address, direct deposit bank account, etc.) and vendor statistics and compare
10. Review new employee records
11. Review short-term employee records
12. Prove reimbursable charges – credit cards, etc.

# IV. MEASURES TO PREVENT, DETECT, AND MINIMIZE FRAUD (cont...)

## D. Insurance



# QUESTIONS?

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