

Combating Fraud In Construction

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Introductions



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Agenda

1. Introduction To Fraud
2. Types And Examples Of Construction Fraud
3. Detecting Construction Fraud
4. Mitigating The Risk Of Construction Fraud

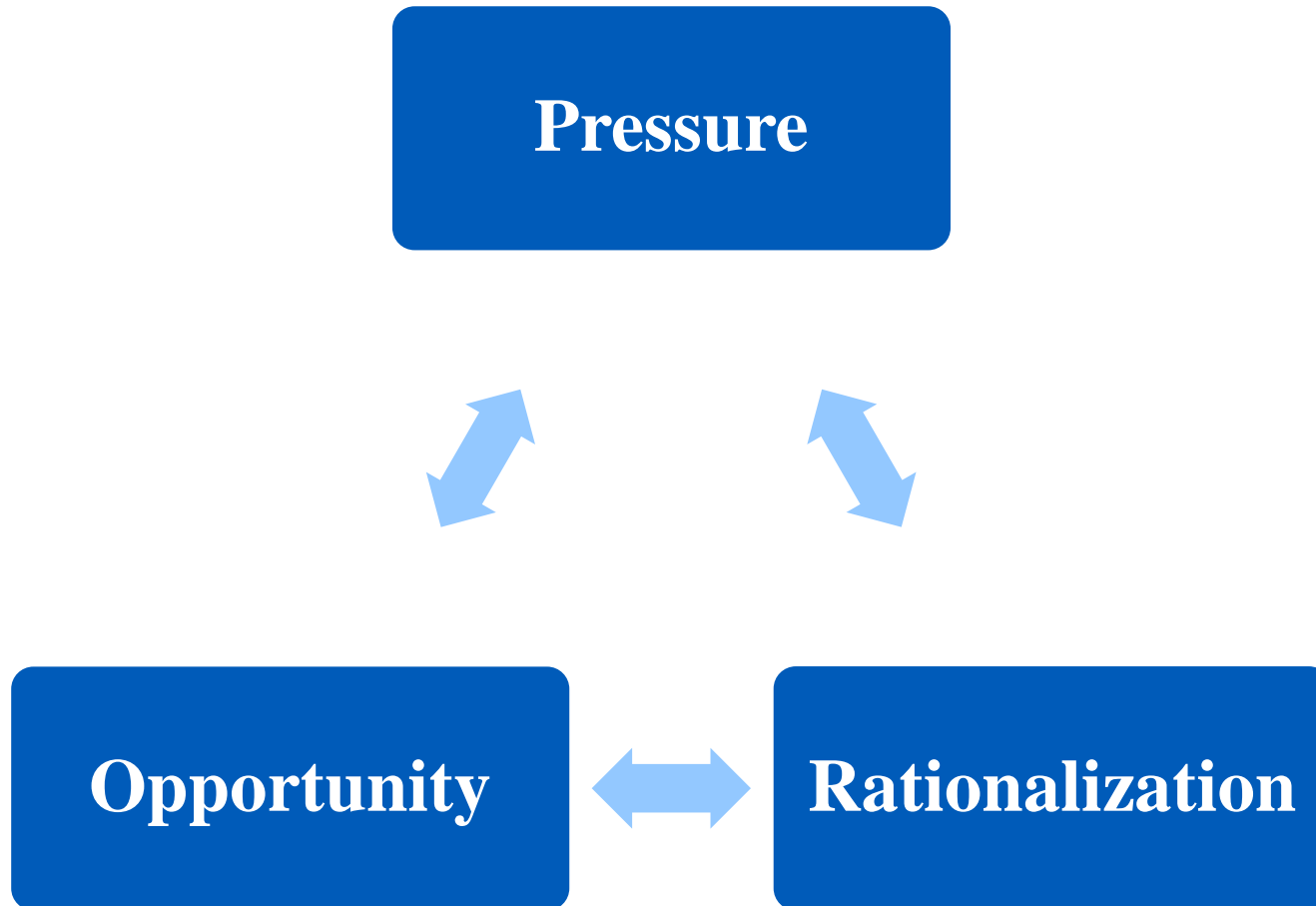
What Is Fraud?

Fraud:

“A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”

Source: Bryan Garner, ed., Black’s Law Dictionary. 8th Ed. (2004), s.v., “fraud.”

Fraud Triangle



Fraud In The Construction Industry

Fraud By The Numbers



- According To The Association Of Certified Fraud Examiners (“ACFE”):
 - 3.9% Of All Reported Fraud Occurs In The Global Construction Industry
 - \$259,000: Global Median Fraud Loss In Construction Industry
- 10%: Estimated Percent Of Total Construction Revenue Lost To Fraud Annually
- Not All Fraud Is Reported

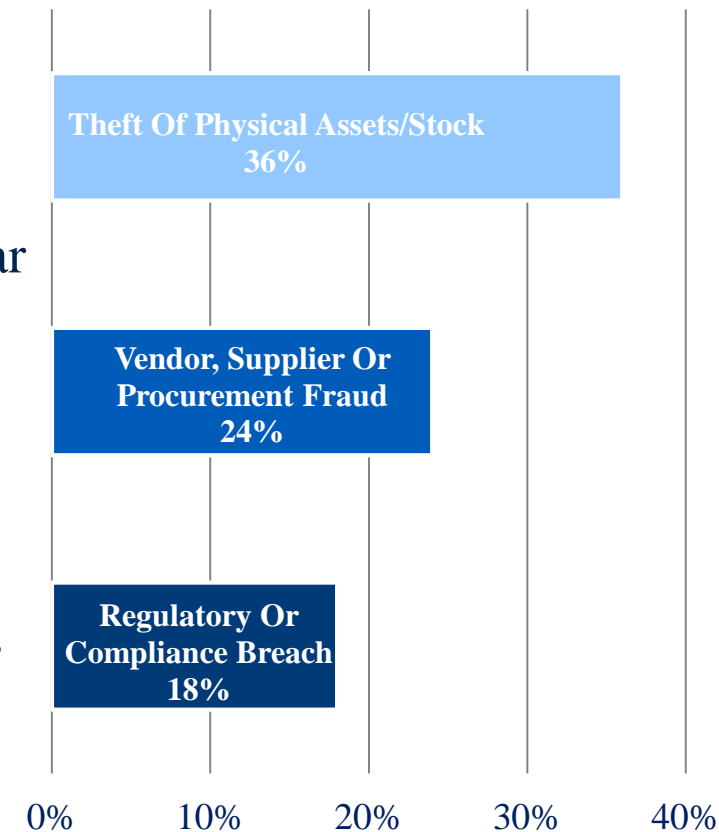
Fraud In The Construction Industry

Fraud By The Numbers (cont.)



- A 2015 Kroll Global Fraud Report Found:
 - 75% Of Construction Companies Experienced A Fraud Incident Over The Last Year
 - 92% Of Construction Companies Felt Their Fraud Exposure Had Increased In The Last Year Due To High Staff Turnover And Entry Into New, Riskier Markets
- Of Firms That Experienced Fraud And The Offender Was Known:
 - 42% Were Led By Senior Or Middle Managers
 - 51% Were Led By Junior Employees

Areas Of Frequent Loss For Construction Companies



Fraud In The Construction Industry

Who Commits Fraud?



- Owners
- General Contractors
- Subcontractors
- Designers / Engineers
- Vendors / Suppliers
- Inspectors
- Public / Government Officials
- Procurement Personnel
- Employees
- Others

Fraud In The Construction Industry

Why Does Fraud Happen?



Pressure	Opportunity	Rationalization
Small Profit Margins	Poor Controls	“Everyone Does It”
Highly Competitive	Small Office Staff	Not Adequately Compensated
Timing Expectations	Fast-Paced Environment	Necessary To Compete
Budget Expectations	Antiquated Cost Systems	Just Borrowing, Not Stealing

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Types Of Fraud Found In Construction



- Bid Rigging
- Corruption
- Asset Misappropriation
- Disadvantaged Business Enterprise (“DBE”) Fraud
- Other Types Of Construction Fraud

Types Of Fraud Found In Construction Bid Rigging



- Bid Rigging Occurs When Contractors Work Together To Unfairly Influence The Bid
- Involved Parties Conspire To Choose Who Will “Win” Bid And The Consolation Prize For Those Not Selected
- Examples Of Bid Rigging Schemes Can Include:
 - Bid Rotation
 - Bid Suppression
 - Complementary Bidding
 - Market Allocation

Types Of Fraud Found In Construction Corruption



“The Wrongful Use Of Influence To Procure A Benefit”

- Examples Of Corruption Schemes Can Include:
 - Bribes / Kickbacks
 - Illegal Gratuities
 - Extortion
 - Conflicts Of Interest

Source: Association Of Certified Fraud Examiners

Types Of Fraud Found In Construction Asset Misappropriation



- Includes Both Theft And Improper Use Of Company Assets
- Examples Of Asset Misappropriation Schemes Can Include:
 - Theft / Use Of Materials For Personal Use
 - Falsified Wages
 - Overpayment / Billing
 - Ghost Employees
 - Shell Companies

Types Of Fraud Found In Construction Disadvantaged Business Enterprise (“DBE”) Fraud

- Purpose Of DBE Program To Increase Participation Of Minority Business Entities In State and Local Procurement
- “DBEs Are For-Profit Small Business Concerns Where Socially And Economically Disadvantaged Individuals Own At Least A 51% Interest And Also Control Management And Daily Business Operations.”
- Examples Of DBE Fraud Can Include:
 - Shell Companies
 - Misrepresentation Of Ownership
 - DBE Does Not Perform Commercially Useful Function

Source: U.S. Department Of Transportation

Types Of Fraud Found In Construction Other



- Improper Change Orders
- Substituting Materials
- Substandard Workmanship
- False Representations
- Financial Statement Fraud
- Others

Example – Xcel Construction Services, Inc.

Case Facts



- Garden View Estates – Detroit
 - Mixed-Use Public Housing Development
 - \$24M In Federal Funds
- Xcel Awarded \$11.7M Contract To Manage Project's Infrastructure Installation
- Alleged Bid Rigging
 - Xcel Executives Colluded With At Least One Other Contractor To Ensure Xcel Presented The Low Bid
 - Conspiring Contractor Submitted A Fictitious, Price-Inflated Bid Which Allowed Xcel To Overcharge In Its Own Bid
 - Conspiring Contractor Was Later Hired As A Subcontractor On The Job

Example – Xcel Construction Services, Inc.

Outcomes



- September 2010 – 7 Individuals Were Indicted And Charged With Mail Fraud, Money Laundering And Other Crimes
- October 2010 – Co-Owner Of Conspiring Contractor Pled Guilty To A Felony Concealment Charge Related To Alleged Garden View Estates Big Rigging
- June 2012 – Trial Of 3 Xcel Executives Resulted In A Mistrial
- August 2013 – 1 Of The Executives Pled Guilty
 - Single Count Of Conspiracy To Defraud The Federal Government
 - Sentenced To 1 Day In Jail, 1 Year Supervised Release
 - Forfeited \$2.2M In Assets

Example – SNC-Lavalin McGill University Project Case Facts



- McGill University Health Centre (“MUHC”) – Montreal, Canada
 - C\$1.3B Project
 - SNC-Lavalin Had 60% Equity Interest In Consortium To Operate And Maintain Facility
- Alleged Corruption Using Kickbacks And Financial Statement Fraud
 - MUHC Officials Received C\$22.5M In Kickbacks From SNC-Lavalin In Exchange For The Contract
 - SNC-Lavalin Booked C\$22.5M Kickback Payment Booked To Another Project To Look Legitimate

Example – SNC-Lavalin McGill University Project Outcomes



- Several SNC Executives Criminally Charged
 - CEO Resigned In March 2012 After Discovery Of Inappropriate Payments
 - Preliminary Hearing Held March 2015, Litigation Is Ongoing
- MUHC CEO Criminally Charged
 - 2011 – Left Position, News Of Scandal Broke Shortly Thereafter
 - 2013 – Arrested In Panama, Passed Away Fighting Extradition To Canada
- SNC-Lavalin Instituted A Company-Wide Focus On Corporate Governance And Ethics
 - Amnesty To Whistleblowers In Workforce
 - Participation In Voluntary Reimbursement Program

Example – Lend Lease U.S. Construction Case Facts

- Alleged Asset Misappropriation And DBE Fraud
- Federal Prosecutors Accused Lend Lease Of Improper Client Billings Of More Than \$19M From 1999-2009
 - “Eight Plus Two” Scheme
 - Billing For Unworked Sick Days, Holidays And Vacation
- Overbillings Alleged On Multiple Projects Including:
 - Citi Field
 - Grand Central Station Renovation
- Federal Prosecutors Accused Lend Lease Of Evading Regulations To Hire Specific Percentage Of DBE Firms
- Whistleblower Led To Investigation Into Alleged Scheme

Example – Lend Lease U.S. Construction Outcomes



- Lend Lease Entered Into A Deferred Prosecution Agreement With The U.S. Attorney For The Eastern District Of New York
- Lend Lease Agreed To:
 - Accept Responsibility For Its Overbilling And DBE Schemes
 - Pay \$55.5M In Penalties And Restitution
 - Institute Extensive Corporate Remedial Measures
- Top Lend Lease Executive Criminally Charged
 - Pled Guilty To A Single Count Of Mail And Wire Fraud
 - 2 Years Probation, 750 Hours Of Community Service And \$175K Fine

Example – Schuylkill Products Inc. Case Facts



- Schuylkill Products Inc. (“SPI”) Manufactured Concrete Bridge Beams For Highway Construction Projects
- CDS Engineers Inc. (“CDS”) Installed Bridge Beams
- Alleged DBE Fraud
 - SPI And CDS Used Marikina Construction Company, A Certified DBE, As A Pass-Through Entity In Order To Win Government Contracts
 - SPI And CDS Actually Performed Work
 - DBE Was Paid A Fee For Use Of Company Name
 - Fraud Occurred Over 15 Years Involving \$136M Of Government Contracts In Pennsylvania

Example – Schuylkill Products Inc. Outcomes



- January 2014 – DBE Owner Pled Guilty
 - Charges Included Allegations Of DBE And Tax Fraud
 - Sentenced To Just Under 3 Years In Prison
 - Restitution Of \$119M To USDOT And \$79,450 To IRS
- January – July 2014 – 4 SPI Executives Found Guilty
 - Charges Included Conspiracy To Defraud USDOT, Wire And Mail Fraud, Conspiracy To Commit Money Laundering And Money Laundering
 - Prison Sentences Ranged From 2 - 7 Years
 - 2 Executives Ordered To Pay \$119M In Restitution To USDOT
 - All 4 Executives Ordered To Pay Restitution To IRS Ranging From \$25,100 - \$82,370

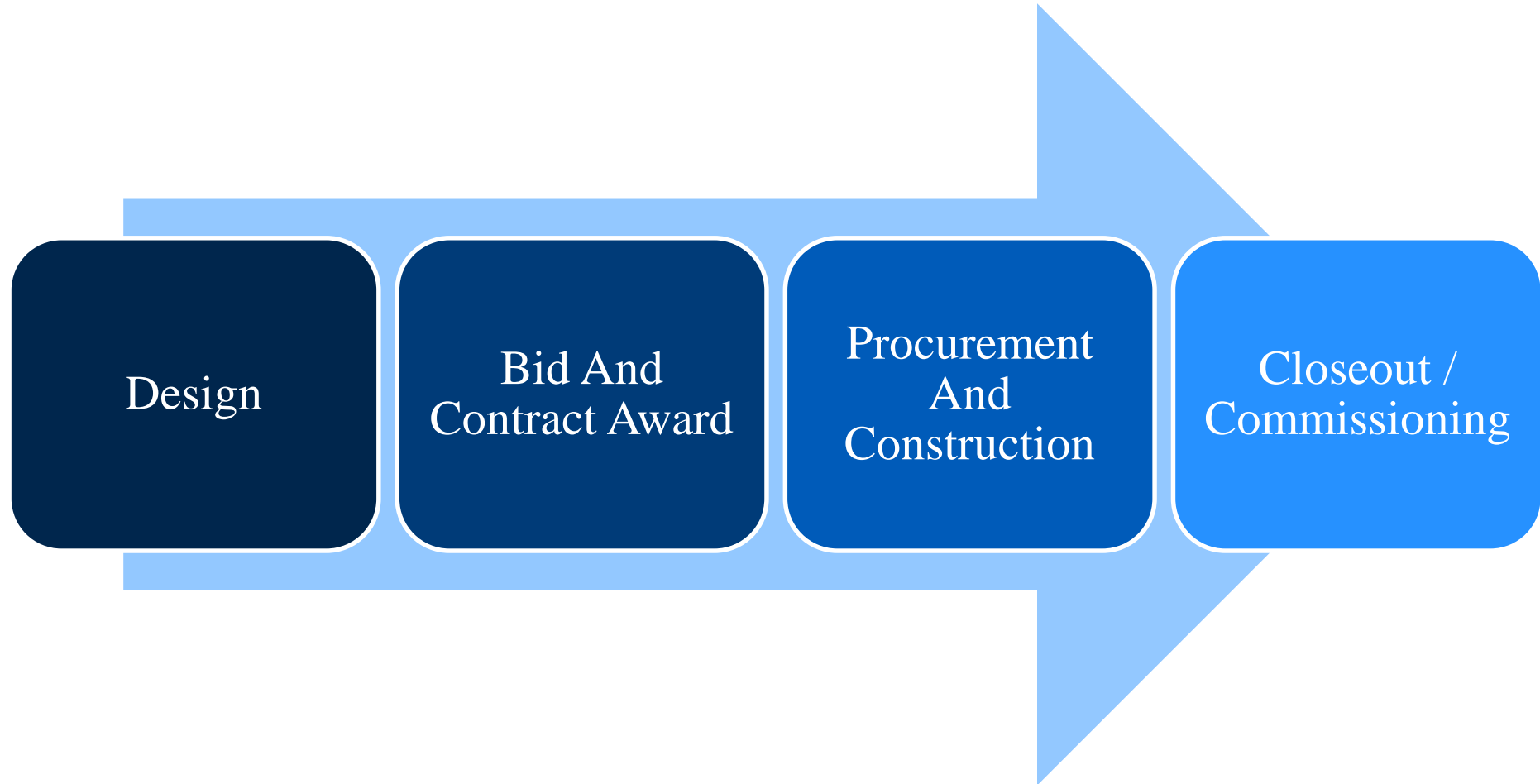
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Detecting Construction Fraud

Phases Of Construction Process



Detecting Construction Fraud

When Does Fraud Happen?



- Design Phase
 - Create Formal Designs Of Construction Plan
- Potential Fraud:
 - Bribes / Kickbacks
 - Overestimate Labor And Materials Costs
 - Project Specifications Manipulation

Detecting Construction Fraud

When Does Fraud Happen? (cont.)



- Bid And Contract Award Phase
 - Contractors And Subcontractors Submit Proposals To Perform Work
- Potential Fraud:
 - Bid Rigging
 - Bribes / Kickbacks

Detecting Construction Fraud

When Does Fraud Happen? (cont.)



- Procurement And Construction Phase
 - Materials And Equipment Ordered, Project Constructed
- Potential Fraud:
 - Overbill For Labor And Materials
 - Asset Misappropriation
 - Improper Change Orders
 - Substitution Of Materials

Detecting Construction Fraud

When Does Fraud Happen? (cont.)



- Closeout / Commissioning Phase
 - Prepare Project For Use, Testing And Inspections, Ensure All Payments Have Been Made And Turn Over To Owner
- Potential Fraud:
 - Bribes / Kickbacks
 - Inspectors
 - Owners' Representatives
 - Failure To Report Discounts Or Rebates / Inaccurate Reporting

Detecting Construction Fraud Methods And Statistics



- Common Methods Of Detecting Fraud
 - Audits
 - Whistleblowers
 - Watch For Red Flags
- Per 2015 Kroll Global Fraud Report, Of Construction Companies That Discovered Fraud:
 - 51% Discovered Via Whistleblower
 - 30% Discovered Through Company Management

Examples Of Audits Used To Find Fraud



- Line By Line Comparison Of Actual To Budget Costs
- Attest Pay Applications' Credibility – Use Scrutiny And Supervision For Errors
- Maintain And Review Copies Of Subcontractor's Documentation
- Gather Proof For Reimbursable Charges
- Reconcile Subcontractor Bills To The Payment Applications
- Compare Specifications Amounts / Measurements To Claimed Actuals
- Track Changes In Contingency Amounts
- Surprise Audits

Whistleblower Education



- Set Up Confidential Hotline
 - Receive Tips From Employees And / Or Vendors
 - Consider Offering A Reward For Reliable Information
- Educate Employees
 - When In Doubt, Report An Issue
 - Retaliation Is Illegal
- Educate Vendors
- Tone At The Top

Common Red Flags That Fraud Exists



Employees

- Unusual Relationships With Vendors
- Do Not Follow Rules
- Show Behavioral Changes
- Constantly Complain
- Personal Financial Troubles
- Medical Or Substance Abuse
- Gambling Problem
- Overly Protective Of Data / Documents
- Never Take Vacations
- Eager To Take On Responsibilities Outside Their Role

Common Red Flags That Fraud Exists (cont.)



Transactions

- Use Of Same Vendors
- Purchasing Policies Not Met
- Purchases From Non-Preferred Vendors
- Sole Source Purchases
- Discrepancies In Price Trends From Year To Year
- Trends Not Relative To Market Pricing
- False Statements In Bid Documents
- Other

Common Red Flags That Fraud Exists Bid Rigging



- High / Low Bids Alternate Between Same Group Of Firms
- Winning Bidder Hires Some Losing Bidders As Subcontractors
- Large Quantities Of Change Orders Issued After Bid Is Won
- Same Contractor Awarded A Large Portion Of Bids From One Customer Or Geographic Area
- Bid Prices Fall When New Contractors Submit Bids

Common Red Flags That Fraud Exists Bid Rigging (cont.)



- All Bids Are Consistently High
- Qualified Contractors Do Not Participate
- Low Bidder Withdraws Bid Without Reasonable Explanation
- Submitted Bids Clearly Fail To Include Specific Requirements Of Project
- Contractors Submit Identical Bids
- Last Bidder Consistently Wins Bid (May Have Access To Insider Information)

Detecting Construction Fraud

Change Orders



- Contracts Are Often Modified Through Change Orders
- Change Orders Are Susceptible To Fraud
 - Collusion Between Procurement Official And Contractor
 - Inappropriate Billing Or Claims Of Extra Work
- Indicators Of Change Order Fraud Include:
 - Excessively Low Bid Followed By Significant Change Orders Shortly After Contract Award
 - Vague Or Incomplete Explanation Of Alleged Change
 - Approval Of Numerous Unsupported Change Orders From Same Contractor

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Mitigating The Risk Of Fraud



- Audit Clauses
- Site Monitoring
- Segregation Of Duties
- Competitive Bidding
- Monitor Construction Costs
- Project Controls
- Other

Mitigating The Risk Of Fraud Audit Clauses



- Implement Contractual Clauses Providing Audit Authority

“The Contractor shall keep full and detailed records and accounts related to the cost of the Work and exercise such controls as may be necessary for proper financial management under this Contract and to substantiate all costs incurred. The accounting and control systems shall be satisfactory to the Owner. The **Owner and the Owner’s auditors** shall, during regular business hours and upon reasonable notice, be afforded access to, and shall be permitted **to audit and copy, the Contractor’s records and accounts**, including complete documentation supporting accounting entries, books, correspondence, instructions, drawings, receipts, subcontracts, Subcontractor's proposals, purchase orders, vouchers, memoranda and other data related to this Contract. The Contractor shall preserve these records for a period of three years after final payment, or for such longer period as may be required by law.”

Source: American Institute Of Architects Standard Contract

Mitigating The Risk Of Fraud Site Monitoring



- “Walk” The Project Site
 - Periodic Site Visits
 - Occasionally Unannounced
- Document Number Of Workers On Site, Work Performed, Etc.
- Monitor Project Deliveries / Orders
- Photographs
- Video Surveillance

Mitigating The Risk Of Fraud

Segregation Of Duties



- Consider Segregating Responsibilities Between:
 - Bid Solicitation And Review And Contract Negotiations
 - Invoice Review And Approval
 - Material Receipt And Approval
 - Change Order Review And Approval
 - Financial v. Technical Evaluation Teams
- Require A Minimum Of Two People To Approve Contracts, Change Orders And Invoices Above A Certain Threshold

Mitigating The Risk Of Fraud Competitive Bidding



- Increase Size Of Bid Pool And Invite New Contractors To Bid
- Compare Submitted Bids To Similar Past Projects And Independent 3rd Party Sources
- Require Bidders To Sign Non-Collusion Affidavit
- Be Knowledgeable About Market Conditions
- Preserve Detailed Bid Records
- Be Aware Of Losing Bidders Hired As Subcontractors
- Educate Employees On Common Signs Of Bid Rigging

Mitigating The Risk Of Fraud

Monitor Construction Costs



- Create Accurate Project Budgets At The Onset
- Periodically Update Budget Estimates
- Monitor Incurred Costs Against Budget
- Audit Incurred Construction Costs
- Reconcile And Document Significant Changes (e.g., Causes Of Cost Overruns) Between Budget Forecasts

Mitigating The Risk Of Fraud Project Controls



- Implement Stringent Requirements For Project Recordkeeping
- Organized System Of Document Maintenance
- Procedures For Transitioning Work
- Ensure Invoices Are Properly Supported
- Confirm Invoiced Labor And Material Rates Reconcile To Contract
- Implement Procedures To Detect Potential Double Billing Or Overpayment
- Require Complete Support For Submitted Change Orders

Mitigating The Risk Of Fraud Other



- Consider Implementing A Whistleblower Hotline To Allow Employees And Vendors To Report Fraud Confidentially
- Consider Asking For Further Documentation When Fraud Is Suspected
- Consider Implementing A DBE Compliance Program To Monitor DBE Relationships
- Thoroughly Review Change Orders To Ensure Legitimacy
- Consider Having Contractor Separately Track Costs For Change Order Work

Mitigating The Risk Of Fraud

Other (cont.)



- Increase Employees' Fraud Detection Sense In The Workplace
- Consider Establishing Formal Policies And Procedures Regarding Fraud
- Consider Enacting An Ethics Policy Training Program For Employees
- Periodically Perform Formal Risk Assessments And Internal Control Reviews
- Require Employees To Disclose Potential Conflicts Of Interest
- Retain Independent, 3rd Party Consultants / Professionals To Evaluate Costs / Processes, If Necessary

Questions?



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