

# Prevent Construction Fraud: Using Good Internal Controls

By John Croy, CIA, CPA, CFE and Ed Williams, CIA

## Executive Summary

In the past five years, the construction industry has experienced a shift in the way construction contracts are managed. First, a movement emerged where building owners favored cost-reimbursable contracts as opposed to the more traditional firm fixed-price or stipulated sum projects. Second, adhering to the Sarbanes-Oxley (SOX) Act of 2002 has required building owners to conduct audits of construction spending, leading to a sharp increase in construction audits.

With the increased level of accountability in the building owner's camp, construction audit specialists are becoming more involved in the construction process from start to finish, instead of coming in at the end to identify opportunities for cost recovery. Construction audit specialists work to investigate the possibility of fraudulent practices and help project management teams put the proper controls in place to ensure projects are managed properly, risks are reduced and both contractors and companies can account for their actions.

## Introduction

Construction projects are typically the most complex and costly undertakings a company makes, and healthcare organizations are no exception.

Accountability is becoming increasingly important as the current economy dictates tighter budgets and leaner operations. The task of ensuring donated, invested, and government-funded dollars are spent wisely and properly has never been more important. Without the proper financial controls and risk monitoring programs in place, a construction project can become an Achilles' heel by exposing a company to various vulnerabilities, including project mismanagement, overbilling, fraud and corruption.

Organizations lose up to 7 percent of their annual revenue to fraud, according to the Association of Certified Fraud Examiners (ACFE). That figure is consistent with the potential overcharges our firm has encountered while conducting construction audits. In the ACFE 2008 *Report to the Nation on Occupational Fraud and Abuse*, the median loss of fraud cases in the construction industry was \$330,000.

The chart below illustrates the instances of overbilling our construction audit specialists identified on client engagements in 2006 and 2007 for the healthcare industry. About one-third of overbilling was payroll and labor-related, while another third was the result of contractors invoicing in excess of actual cost. Our statistics do not reflect what portion was due to errors and what may have been intentional acts.

## Construction Overbilling by Category for the Healthcare Industry

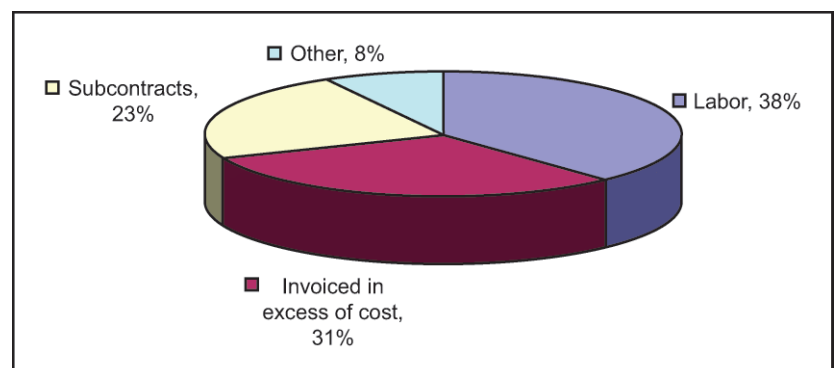
Third-party auditors specialize in construction services work throughout

the entire construction process to help companies improve contract language for clarity, optimize processes and identify overcharges. Whereas, construction audit specialists work to investigate the possibility of fraudulent practices and ensure projects are managed properly, risks are reduced and both contractors and companies can account for their actions. On average, a construction audit conducted by our firm identifies overcharges totaling between eight to 12 times more than the cost of the audit.

## Construction Project Management

The first step to effective construction project management is to identify where risks of fraudulent disbursement and corrupt practices may exist. The second step is to implement controls throughout the general construction life cycle to mitigate these risks.

The following list identifies potential fraudulent and corrupt practices that can occur during a construction project and suggests controls that can mitigate risk at every stage of the construction life cycle.



## Fraudulent Disbursements

Fraudulent disbursements are schemes which result in a building owner making payments to the contractor based on false pretenses. Here are just a few examples.

### *Ghost employees*

Invoicing for non-existent employees or for hours not worked is common in cost-reimbursable (actual cost in accordance with the contract) construction projects. Sometimes, contractors continue to invoice for terminated employees or employees who are no longer assigned to the project. Contractors should have validating internal controls in place, including a process for swiping employee badges when workers enter the construction job site, to prevent this possible misstep.

### *Falsified wages*

Falsifying wages involves invoicing labor in excess of actual cost and/or submitting falsified payroll information. In addition to hours not worked, individuals may be invoiced at the incorrect labor classification rate. For example, a contractor may invoice an employee as a journeyman when he or she is actually working as an apprentice. Errors of various kinds commonly occur in the area of wages; therefore, audits should be performed to trace the amount invoiced for the employee to the employee's actual compensation rate.

A contractor may be required to compensate its employees according to a prevailing wage rate agreement. To demonstrate compliance with this requirement, a contractor is normally required to submit certified payroll reports providing each employee's compensation. Contracts with this requirement should contain penalties for non-compliance.

### *Billing schemes*

In the billing scheme, a contractor may submit an invoice, prompting the building owner to issue a check. While the check is legitimate, the underlying documentation supporting the check is fraudulent. The billing scheme is dependent on the type of construction contract: cost-reimbursable or firm fixed-price.

Cost-reimbursable contracts generally require an invoice for costs incurred in accordance with the contract. To mitigate the risk of the contractor invoicing in excess of the actual cost, building owners should require a summary of the job cost from the contractor with every invoice. Historically, having the architect sign-off on the invoice was viewed as a good control, however we are seeing that this practice is diminishing because owners have not seen that this practice enhances controls.

For firm fixed-price contracts, the contractor is normally required to invoice based on the percentage of completion. A contractor may "front-end load" the invoice, charging for services not provided. While the contractor is entitled to the fixed price at the end of the project, "front-end loading" is a means for the contractor to receive cash payment before he is entitled to the funds.

*Invoicing for non-existent employees or for hours not worked is common.*

The owner should conduct monthly job-site visits when the contractor submits an invoice. Reviewing the percentage of completion for each line item or schedule of values the contractor invoices helps to reduce the risk of front-end loading.

## Corrupt Practices

In the ACFE report, the most common instances of fraud involved corruption, which occurred in 27 percent of all cases. Corruption typically includes two bribery schemes: kickbacks and bid rigging. Both are avoidable with preventive controls.

### *Kickbacks*

Kickbacks are undisclosed payments the contractor makes to an employee of the building owner. In the construction industry, this may include approval of a change order as part of the overbilling scheme. To prevent kickbacks, the building owner should establish levels of segregation of duties. Appropriate departments and individuals should be involved in reviewing invoices, and change orders with appropriate

authorizing sign-offs should be executed with the contractor.

### *Bid Rigging*

Anytime a building owner's employee fraudulently controls or circumvents control in the procurement process, it's considered bid rigging. In return, the employee typically receives services from the contractor, such as the contractor doing work at the employee's home at no charge. The owner should establish a bid-opening process in which other employees are present. For cost-reimbursable projects, an evaluation team should be established to determine the award of the contract.

Contractors also could collude on a competitive bid so they all benefit from the procurement process below market rates. An unsuccessful bidder performing work as a subcontractor may allege bid rigging occurred during the award process.

With respect to bid rigging the main concern is not the type of bidding process that is used, but whether there is an aggregate segregation of roles so that the project manager is not the one receiving and opening bids, as well as receiving information on the contract.

## Controlling Risk at all Stages

To ensure building owners are only paying for the goods and services that were specified, internal auditors need to ensure implementation of key controls has occurred. The following controls should be implemented for each stage of the six stages of the construction life cycle to provide clear direction for contractors and to reduce the potential for conflict during construction.

*Stage 1: Awarding Construction Contracts*—Ensure the award process has adequate internal controls for requesting, receiving and evaluating bids and proposals. The process also should ensure the project team has the experience and the technical and financial capabilities to provide the scope of work.

*Stage 2: Setting Contract Terms and Conditions*—Ensure all construction contracts include a right-to-audit clause. This clause is important because it allows building owners and their representatives access to the contractors' accounting records to validate costs and protect against potential irregularities. The right to audit clause is an important clause to have in the contract and it should be included in all forms of delivery methods. There is a series of other clauses that can and/or should be included in the contract terms and conditions. These include the right to self-performed work, the right to final specifications and clauses identifying allowable costs.

*Stage 3: Budget and Cost Forecasts*—During construction, monitor project costs on a regular basis as appropriate for the project. The project budget and cost forecast estimates should contain the original budget; budget changes; forecast; actual cost incurred; commitments to date such as agreements for goods and services; uncommitted costs, such as agreements for goods and services not in place; and estimated cost to complete or final estimated cost. The project management team should be monitoring the project costs as part of their responsibilities. The auditor's job is to help establish the monitoring and then to validate it is occurring and that other controls are working as expected.

*Stage 4: Applications for Payment*—We calculate that about 50 percent or more of applications for payment contain mathematical errors, such as invoicing for unapproved change orders or invoicing for fees and services not provided. It is critical to verify financial accuracy against an internal, customized checklist of common errors for fraudulent charges.

The checklist can be built from the circumstances surrounding the contract and payment terms.

*Stage 5: Change Orders*—Validate the estimated cost included in the change order to the cost actually incurred to determine whether the costs were included in the original bid. This avoids paying for an item multiple times. Change orders should have the appropriate levels of review and approval before moving forward.

We calculate that about 50 percent or more of applications for payment contain mathematical errors.

*Stage 6: Project Scheduling*—Like the budget, the project manager should review the project schedule, and an updated version should be provided to management on a regular basis as determined by the project management team. That way, if the project schedule begins to slip, management can determine whether to accelerate the current schedule to remain on time and within investors' expectations.

*Stage 7: Construction in Progress*—Establish policies and procedures to identify costs included in the construction-in-progress account, including payments to the general contractor; payments to the architects; payments to third parties directly involved in the project; internal incremental labor costs directly associated with the construction project; and interest expense pursuant

to Statement of Financial Accounting Standards No. 34: Capitalization of Interest Cost.

*Stage 8: Contract Closeout*—Policies and procedures are necessary to assure building owners at the contract close-out that costs billed have complied with the contract terms and that the following have occurred: all lien releases have been received, ensuring payments have been made for goods and services; procedures are in place to ensure punch-list items are completed; and if the project is a cost-reimbursable project, a closeout audit was performed to validate costs incurred by the contractor.

### Conclusion

Exceeding a multimillion dollar construction project budget is frustrating enough; learning that the increased costs could be attributed to unauthorized charges is disturbing at best. The relationship between a building owner and a construction contractor should be built on trust prior to groundbreaking, and it is essential for organizations to validate that trust upfront as well as during the construction process. Having a well-written contract with internal controls in place before undertaking a construction project will reduce inadvertent and intentional errors.

With prevention and accountability in mind, construction projects stand to gain the most improvement through controls implementation. Effective construction project management contributes to a project delivered on time and within budget. It also encourages an open and trusted relationship between building owner and contractor, avoids surprises and minimizes litigation if a relationship goes sour. **NP**

## Authors



*John Croy, CIA, CPA, CFE, is global director of construction services for Jefferson Wells. He can be reached in the Phoenix office at 602-643-1600 or at [john.croy@jeffersonwells.com](mailto:john.croy@jeffersonwells.com).*



*Ed Williams, CIA, is an engagement manager—internal audit and controls for Jefferson Wells. He can be reached at the Denver office at 303-324-6106 or at [ed.williams@jeffersonwells.com](mailto:ed.williams@jeffersonwells.com).*