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Accounting fraud, in general terms, is defined as the intentional misrepresentation or alteration of accounting records regarding revenues, expenses, financial reporting and other factors for either personal or business/entity gain. Construction fraud more specifically involves deceit in the performance of construction contracts. The early 2000s seemed to be the golden age of accounting fraud cases; but over the past few years the spotlight has dimmed on these big and complex accounting fraud cases. However, it is a myth that fraud is a big scheme that should have been caught sooner or should have been easy to detect – the truth is that most frauds start small and continue to get bigger and bigger until someone notices something different or unusual. Therefore, it is important for all businesses to understand some of the basics of fraud, recognize some tell-tale signs of construction fraud, and to have in place certain controls to minimize exposure.

Underlying Causes of Construction Fraud:
Some of the basic underlying causes for construction fraud are:

› Economic pressure – for example: risk of bankruptcy, price volatility in labor and materials, low profit or margins on jobs, and tight bank credit
› Cost-based contracting approaches – potential for inflating or transferring costs erroneously to jobs
› Contracts where the scope is not defined until after the price is set – potential manipulation of contract performance if scope is greater than price and/or resultant profit estimated to be realized is too low
› Construction joint ventures – related party transactions should be reviewed carefully

Who Commits Fraud:
The people that commit accounting/construction type frauds do not fit the typical “criminal” profile. Their motivations are typically similar; however, anyone in your organization could commit fraud should the situation be right. Fraud can be committed by: contractor employees; owner employees; contractors, sub contractors and consultants, and any participant in either a successful (windfall profits, etc) or unsuccessful (significant loss on project, etc) projects.

Construction Fraud Schemes:
Not meant to be all inclusive, but some typical construction fraud schemes to be aware of are:

› False application for payment
› Billing for work not performed (risk of a cost-based contracting approach)
› Collusion, related parties, and conflicts of interest (risk associated with construction joint ventures)
› Change order manipulation
› Manipulation of the schedule of values and contingency accounts
› Substituting or removing material
› Diverting lump sum charges to time and material costs
› Diverting purchases and theft of equipment or tools
› Non-payment of subcontractors and material suppliers
› False representations

The schemes noted above are broad categories; and within each of the categories are a number of specific methods in which the fraudster could perpetrate the fraud.

Fraud Red Flags:
The following red flags are indicators that fraudulent activity could exist; they are not absolute indicators of fraud occurring, but nevertheless, should be investigated to ensure that fraudulent activity is not present.

› Application for payment form that is unusual in presentation or structure
› Missing or disorganized billing documentation
› Use of contingency funds without proper or timely explanation of usage
› Changes in the schedule of values without proper or timely explanation of changes
› Subcontractor complaints regarding delays in payment
› Missing subcontractor lien waivers
› Unusual bid patterns
› Unsuccessful bidders hired as subcontractors
› Unauthorized changes in or missing time records
› Related parties and/or common ownership

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**Basic Fraud Tests:**
Should you suspect fraud, some basic tests that you can conduct before calling Keiter.
- Schedule out and reconcile the pay applications and compare to contract and to the job cost report
- Compare actual to budget on a line item basis with the contract
- Track changes in the schedule of value and contingency account and get supporting documentation for those changes
- Compare change order signatures dates to when the work was completed
- Inventory lien waivers
- Take an inventory of equipment and inventory left on site to what is expected
- Perform supplier confirmations of billings and payments
- Reconcile subcontractor bills to pay applications
- Review the subcontractor bid selection process and documentation of selection

**Basic Controls That Should Be In Place:**
The following basic controls will not entirely safeguard an entity from accounting/construction fraud cases; however, it is a good start to ensuring that the right tone at the top is set for employees and business partners to understand the severity of accounting/construction fraud:
- Set the right attitude at the top about non-tolerance of fraud
- Provide employees and business partners with compliance and ethics programs
- Maintain a hotline or other anonymous reporting mechanism for employees to report unethical behavior without fear of retribution
- Define conflicts of interest with employees and business partners, and monitor and update changes periodically
- Ensure scope of construction project is properly defined prior pricing or starting the project
- Maintain receiving control of materials
- Include a right to audit clause in subcontractor contracts and conduct surprise audits
- Maintain a pay application checklist

For more information regarding construction fraud, please contact Doug Nickerson at dnickerson@keitercpa.com or your Keiter engagement team.

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