Four Common Construction Fraud Schemes

(and common sense controls to mitigate risk)

Construction Fraud Risk Is On the Rise

If you think that your construction project is not at risk for fraud, think again. The AFCE's 2010 Report to the Nations on Occupational Fraud and Abuse indicates that on an average, 5% of a company's annual revenue is lost to fraud. In the construction industry, Grant Thornton LLP estimates this average to be even higher, at 6% in the pre-recession years and growing to an average of 10% currently. With increased awareness of fraud across the board in all industries, why is the construction occurrence rate still growing?

The Fraud Triangle

Consider Donald R. Cressey's traditional Fraud Triangle, which demonstrates the basic components that make fraud more likely to occur. The three sides of the triangle represent Motives (or Pressure), Opportunities and Rationalizations. In times of economic uncertainty like those we face today, it is easy to identify areas on each side of the triangle that could buckle under the weight of a construction project, even if the project is successful, well-designed or under budget.

During the housing market crash and downturn in construction, many contractors are faced with greatly reduced annual revenues that could be below their break-even point. Because of the economic downtown, many contractors may be faced with not getting enough work to cover just their fixed costs; as a result, their risk of going out of business increases. In today's economic climate, there are fewer projects out there on which to bid and many hungrier contractors participating, hoping to add the revenue to their new, diminished base. There is tremendous Pressure to win the bids just to survive as a company. Contractors may be tempted to under bid, or bid less than cost, just to win the work and keep the revenue and cash flowing into the business. The problem is that the cash flow in this situation eventually dries up and the contractor must finish the job at a loss, covering his losses with positive cash flow from future projects. This type of situation lends itself to over-billing and other types of fraud schemes contractors can either make up their losses or improve cash flow.

Construction projects are complex and sometimes disjointed in the areas of responsibility. There are also exchanges of money among many parties such as project owners, construction managers, general contractors, subcontractors and vendors. Usually project managers that are involved with the details only see a small piece of the project and the high-level managers are often not involved with the details. Often a project manager approving an invoice does not fully understand the engineering aspects of the tasks being performed and therefore can be "fooled" with billings that do not make sense. In short, the complexities of a capital project can create many Opportunities for fraud to occur.

The third side of the triangle is Rationalization. When a construction project is at risk of being left uncompleted, the rationalization to do anything keep it going, even by means of fraud schemes, becomes increasingly more likely. The project owner may also ignore obvious fraud, or approve over- billings with minimal scrutiny because often approving additional billings is better and perhaps less expensive than facing the abandonment of an unfinished project. Additional fraud schemes can include schemes related to a project owner's employees who could have been a part of an under- bidding process with a contractor to appear to construct the project at a favorable, but unattainable price; and later have to accept fraudulent billings to resolve problems created during the original, low (below cost) bid acceptance.

Considering all the pressures upon owners and contractors to deliver fewer construction projects at the lowest possible cost, the temptation to cut corners and venture over the line into the fraud arena has never been greater. We will discuss some of the most common fraud schemes used in the construction industry however; our discussion is by no means exhaustive. There are as many ways to be fraudulent as humans are creative. We will also outline some controls that management can implement early in the project life cycle to increase the likelihood of prevention or early detection of the fraud.

Tax Evasion

Contractors that run into cash flow problems and/or a project loss situation sometimes do not file state or federal payroll taxes and/or income taxes. They may also hire illegal aliens as laborers so that they can pay them lower wages ("off the books") and not pay related payroll taxes. Alternatively, laborers that are U.S. citizens can be paid cash wages without the withholding of both employer and employee taxes. Often times, contractors have incorporated the estimated payroll taxes as part of their scheduled values cost when bidding contracts. Therefore, if a contractor can get away with not paying taxes obviously results in additional contractor profit. One such case is described as follows:

> *"On November 16, 2009, in Las Vegas, Nev., Robert Kahre and his sister Lori Kahre, were sentenced to 190 months and 72 months in prison, respectively.*
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> *..between 1997 and 2003, Robert Kahre owned and operated six construction-related businesses in Las Vegas and paid employees over $100 million in cash wages. Additionally, Kahre provided a payroll service to approximately 35 other construction contractors who employed thousands of employees. Robert and Lori Kahre devised and used a payroll scheme that concealed and disguised the true amount of income received by his*
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> *employees and the employees of the companies for which he provided payroll services. Robert Kahre claimed to pay employees in gold or silver coins, but which were actually immediately exchanged for pre-determined envelopes of cash."*

The best way to avoid getting deep into a project with a contractor that evades taxes is to ensure management properly performs a robust vetting process of all general contractors and subcontractors during the bidding process. The project owner should become familiar with contractors in the area and know of their reputation for how they do business. A lot of information about a company is available publically and a reputable contractor will be willing to provide additional financial information if requested. Once the bid has been awarded, ensure that there is an audit clause in the contract granting the project owner the right to audit any cost that is part of the contract scheduled values (for lump sum contracts) or part of billed time and material for cost-plus contracts. An experienced audit staff should review payroll and income taxes, including cancelled checks or evidence of wire transfers, as part of an early and comprehensive review of the contractor's cost accounting records.

Non-Payment of Subcontractors and Material Vendors

If a contractor has won, a bid submitted for a lump-sum contract amount, which is at or below his anticipated costs, or if the contractor has underestimated his costs, the loss situation will eventually manifest itself in the form of cash flow problems. In order to continue operating the contractor may stall paying subcontractors or vendors, pay the oldest invoices with billing proceeds for the work of subsequent subcontractors or fail to pay subcontractors at all and bill the project owner for their work. An example of this type of fraud scheme was reported on WGMD 92.7 talk radio on October 14, 2010:

> *"ERIK K. MCGINNIS OF MILTON, DE WAS ARRESTED IN MIAMI, FL UPON RETURNING TO THE UNITED STATES AFTER SPENDING THREE YEARS IN CENTRAL AMERICA AND THE CARIBBEAN. MCGINNIS, AGE 34, WAS WANTED BY THE REHOBOTH BEACH AND DEWEY BEACH POLICE DEPARTMENTS ON SEVERAL COUNTS OF CONSTRUCTION FRAUD AND CONTRACTOR FRAUD....POLICE SAY MCGINNIS HAD BEEN PAID TO BUILD A $200,000 HOME – BUT FAILED TO PAY HIS SUBCONTRACTORS…"*

Again, the best way to avoid such a situation is proper vetting, executing thorough background checks of potential contractors and performing an early audit that includes steps to ensure that subcontractors are paid before a contractor's application for payment is approved and paid. If a contractor's cash flow situation is so tight that he cannot pay his subcontractors unless he is paid for the work first, then the project owner should consider directly paying the subcontractors.

Project owners should keep a line of direct communication open with the subcontractors, which excludes the contractor, in order to learn of potential complaints directly such as potential project delays or failure to receive payment from the General Contractor for work performed.

Charging Lump Sum Work as Time and Material Cost

Complex projects over many years of construction that are lump sum or GMP (guaranteed maximum price) often enhance the scope of the project, adding design, construction or temporary structures over and above what was originally planned. Change orders are issued for work related to scope modification and the change orders are often contracted as cost-plus work whereby the contractor is paid for whatever reasonable costs a contractor incurs plus a fixed fee percentage.

There is a monetary incentive for a contractor to charge for work performed on the original, lump sum portion of the contract to the change order instead. Doing so would mean a contractor would be paid twice for their costs. A contractor is paid under the lump sum portion of the contract since the contracted amount is based on scheduled values and a profit percentage. The contractor will be paid this contract amount whether they incur the cost or not, as long as the contractor completes the job. The change order work is based on actual costs incurred, so by moving the cost from the lump sum portion to the change order, the contractors not penalized on the lump sum. The contractor also is paid on the change order for time and materials.

The contractor is counting on inexperienced project budget personnel who do not understand the nature of the work performed or who are not documenting the fieldwork on a daily basis.

The best way to prevent this type of contractor fraud is to have an experienced engineer or field inspector scrutinize billings. The engineering or inspection personnel should also be visiting the site every day, writing a narrative description of the work being performed that day with reference to the relevant work orders and change orders, and documenting the laborers, equipment and materials being used on the cost-plus portion of the project. Laborers should also be documented for the lump sum portion, compared with certified payrolls and validated against scheduled values on a regular basis.

An experienced engineer is a more expensive employee than inexperienced project budget staff, but experienced engineers will pay for themselves tenfold by disallowing erroneous billings. Once the contractor understands the owners' detailed level of review, the billings will become more accurate and the risk of billing fraud will diminish.

Co-Mingling Of Job Costs, Charging the Project for Costs of Another

The contractor who appears disorganized and is constantly having cash flow problems or is operating at a loss, with no explanation as to the reason for their cash flow problems, may be co-mingling resources and costs with other projects. The contractor could be charging time and materials that belong to other projects or he could be allocating excessive amounts of overhead to the project.

When a contractor bids a lump sum project, he is required to submit scheduled values to support his bid costs and profit. The scheduled values itemize the contractor's anticipated cost in each category such as a particular type of labor, the rental or purchase cost of equipment required, and the cost of materials used for the construction project.

If the contractor is using the same group of laborers or same type of materials and equipment on several jobs simultaneously, and the contractor does not have an efficient method for tracking and separating project costs, he may be or co-mingling costs between projects inadvertently or unintentionally. Then he may claim a loss on one project and ask for additional reimbursement from the owner in order to disguise cost overruns on another project. Alternatively, costs for personal construction (for example a new home for the contractor) could be buried in another project's costs.

The best way to avoid such a situation is to make the contractor accountable for his costs against his scheduled values early in the project and then at regular intervals thereafter. If costs are exceeding the scheduled values in any given category or area, it should be determined immediately if the contractor is performing within the scope of the original contract or if the contractor has a valid claim for additional reimbursement under a change order. If a cost is off-track it should be detected and dealt with sooner rather than later when there is no opportunity to remedy the cost overrun.

Daily inspections will also prove invaluable at detecting areas of potential, unusual cost overruns. The daily reports written by the field inspectors, along with the certified payrolls provided by the contractor should make it easier to detect labor, equipment and materials that are being used on another project or delivered to an unexplained location.

A regular audit should be performed by the owner's audit or accounting staff to ensure that the contractor maintains reasonable allocations of overheads that are consistent with the percentages originally projected in his scheduled values.

TRUST YOUR COMMON SENSE, BE INVOLVED AND ASK QUESTIONS

Many fraud scenarios could be avoided if project owners or construction managers were more involved in the vetting of the contractor and then with the day-to-day activities at the project. Construction managers make better decisions if they document the daily activity and use the knowledge gained from their involvement to make common-sense judgments about the contractor billing.

A good fraud prevention step is for the owner to know with whom he is doing business, take the time to investigate their reputation, and understand how the contractor does business. Visit their offices, take a tour of their facilities and interview personnel who perform project accounting functions. If something appears unusual or "off", there is probably a good reason why it does.

Project management personnel with less experience hesitate to ask the contractor questions and possibly look foolish or inexperienced. The questions need to be asked and follow-up performed until a satisfactory answer is obtained. Contractors who participate in fraud schemes count on the project manager giving up when they get the run-around.

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