

# FRAUD, FORGERY & OUTRIGHT THEFT:

## STRATEGIES TO PROTECT PROJECT FUNDS

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## Contractors who have employees and work with vendors

are vulnerable to misappropriation of money and assets. Among industries most affected by fraud, construction ranks eighth, according to the Association of Certified Fraud Examiners 2016 Global Fraud Study. The median loss of the 86 construction cases studied was \$259,000. The impact of such losses can be devastating for companies, especially smaller ones that don't have the resources to absorb them.

## **FRAUD, FORGERY AND OUTRIGHT THEFT: STRATEGIES TO PROTECT PROJECT FUNDS**

Theft comes in all shapes and sizes. Employees, vendors and subcontractors—even those a contractor has worked with for years—can act unscrupulously and even illegally to siphon money from a company. From falsifying invoices to funneling money to phantom companies, people with ill intentions are creative in figuring out ways to defraud. Contractors have to remain vigilant to detect when fraud or theft is occurring and to set up procedures to regularly assess their operating systems for vulnerabilities. Knowing the ways in which fraud commonly occurs in the construction industry is an important first step to reducing risk.

### **FOLLOWING THE MONEY**

Asset misappropriation involves the theft or misuse of an organization's assets by disbursing funds through fraudulent means. Billing, payroll and expense reimbursement systems can all be avenues for this type of fraud. Some real-world examples include:

- a dishonest employee creates an outside shell (dummy company) from which nonexistent services or materials are being “purchased”;
- an employee alters or reissues an invoice for a greater amount, pays the vendor through other means and pockets the difference;
- an employee charges purchases for his or her own home improvement project on the company account at the local home improvement store;
- an employee changes the address of a vendor to a post office box, receives the check and deposits it in his or her own bank account for cashing; and
- a payroll administrator continues to issue paychecks to an employee who quit, but takes them for him or herself by routing the direct deposit to his or her bank account.

The key to detecting and ultimately preventing asset misappropriation is establishing checks and balances within purchase approval and payment disbursement systems. In many small companies, one employee often oversees both of these functions, which gives them lots of opportunity and cover to set up fraudulent schemes. Instead, establish some cross-departmental procedures so that no person is operating without knowledge or oversight from another employee.

Another safeguard is establishing limits on the quantity of disbursements to single vendors and maximum amounts of individual disbursements. At a minimum, require larger disbursements be approved before funds are released. Other prevention and detection tips include:

- periodically compare addresses of vendors to employees and other vendors;
- require supporting documents of significant vendors, such as project-specific invoices, itemized bills of loading and reference to the purchase order;
- review endorsements of checks for proper processing; and

- be sure bank statements are received by employees who are not connected with the disbursement process, examine checks for endorsements and alterations and match statements to checks.

## CRIME THAT PAYS

In construction, corruption can include conflicts of interest, bribery, illegal gifts and extortion. Real-world examples include:

- an employee gives a job to a vendor who submitted a higher bid because of a personal relationship with that vendor;
- an employee in charge of purchasing vehicles agrees to pay a dealership more for the vehicles in exchange for receiving a free car after a certain number of company vehicles are purchased; and
- an employee demands payment to select a vendor for a project.

Rotating major purchasing responsibilities among employees is one of the best ways to reduce risk of corruption. Separate purchasing responsibilities from purchasing requests. Establish competitive bidding practices so that bribery and extortion are less likely. Appoint someone outside the purchasing process to review estimates, purchase orders and pricing, and to verify delivery or service completion.

## SUBCONTRACTORS AND FRAUD

Most vendors and subcontractors are committed to performing high-quality work to win more business and to protect their reputations. Those who are not scrupulous look for ways to profit by manipulating standard procedures. They may bill for unperformed work, collude with other subcontractors to rig bidding procedures, manipulate change orders, substitute lesser quality material, falsely represent their compliance with specific contract requirements and even steal equipment or tools.

## PREVENTION AND DETECTION TIPS

To reduce risk of subcontractor fraud, as well as asset misappropriation and corruption, consider these fraud prevention techniques:

- Create an ethical culture from management and ownership down.
- Document and test internal controls regularly to identify weaknesses.
- Implement and communicate company policies to all employees. Make sure this is done on a regular basis. Giving new employees a company handbook when they start work is not enough.
- Establish periodic job rotation policies and mandate vacations. Fraudulent practices are harder to maintain when someone is filling in for another employee while he is on vacation.

- Implement physical safeguards.
- Consider using surveillance systems for monitoring access to facilities and supplies.
- Implement an employee or company hotline system for reporting suspected fraud.
- Conduct periodic performance reviews for all employees.
- Implementation of independent verifications.
- Strategically segregate and separate important duties affecting the bidding, procurement, purchasing and payment processes.
- Conduct an annual independent financial audit.
- Create physical controls over company documents and records.



## There are news reports every week

about schemes to embezzle organizations as small as Cub Scout troops and as large as the federal government. Parties in the construction industry are particularly susceptible due to the large volume of transactions between owners, contractors, subcontractors, vendors and other suppliers. The first step to avoiding these losses is to create a culture of honesty, but the next step of reasonable monitoring and auditing is essential to the business.



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