identifying fraud

hot spots:

how to safeguard your company from internal fraud

Although all construction companies strive for excellence in creating and maintaining ethical working environments, implementing ethics and compliance programs can create administrative headaches. Moreover, while an ethics and compliance program may meet all statutory and regulatory requirements, it may not be structured to detect employee fraud or misconduct that can lead to significant monetary loss and civil and/or criminal penalties.

These costs, plus consulting fees a company may incur to resolve allegations of fraud or misconduct, could cripple a company’s bottom line. (In 2012, the median loss stemming from internal fraud cases in the construction industry was $300,000, according to the Association of Certified Fraud Examiners.) As a result, construction companies, especially those with federal projects, should implement internal compliance mechanisms that go beyond the statutory requirements.

Contractors can institute specific practices to help detect and prevent employee fraud or other misconduct. This article will identify common areas of fraud, review the general protocol for conducting internal investigations, and provide best practices that companies can put in place to detect and prevent illegal activity.

Common Areas of Fraud or Misconduct

Although fraud may be committed in various ways, certain patterns of misconduct are common in construction companies.
Improper Billing

Procuring materials and supplies from subcontractors and suppliers can be a hot spot for employee fraud. Invoices and change order requests may be inflated by a PM (or any other employee with the authority to do so). The company then pays the inflated price, and the supplier receives payment for the actual cost of the supplies or services (plus a reasonable markup) while the excess amount is diverted into the employee’s pockets.

This type of fraud is often a collaborative effort between the employee and the subcontractor/supplier. Commonly, the fraud begins with the employee directing a subcontractor or supplier to provide an intentionally inflated request for payment. The employee signs off on the request and the company pays the full amount without any knowledge of the fraud.

An employee may also attempt to defraud a company by creating a shell entity and invoicing the employer for goods and services that are never provided. In this scenario, the employee submits invoices from a fictitious company, approves them, and then disburses the money to the fictitious entity. The money ultimately finds its way from the shell company to the employee’s personal account. These shell entities are often described as providing professional or consulting services so that their tangible benefit to a project is more difficult to track.

Construction companies can look for this type of fraud in these specific areas:

- **Subcontractor invoices/change order requests**: A single individual may inappropriately have sole authority for handling such documents. Using a single point of contact for all subcontractor/supplier dealings on a project limits third-person oversight and shields transparency. Invoices and change order requests must be approved by a third party to help combat the potential for fraud.

- **Vendor verification process**: A company should implement this process for new subcontractors and suppliers to ensure that they are legitimate businesses and not shell entities. This review is particularly important when dealing with newly formed entities that do not have track records. Each time a new subcontractor is used – especially one that provides professional or consulting services – it should be verified.

- **Contingency funds**: Use of these funds must be monitored closely. If a project budget includes a line item for contingency funds, an employee with control over the project finances could conceal overpayments or embezzled amounts by utilizing these funds.

Company Credit Cards

Although providing company credit cards may eliminate some administrative burden and can facilitate day-to-day business operations, CFMs should monitor their use to ensure that employees do not charge unallowable personal expenses to a project. Such charges, even small ones, can significantly reduce a company’s profit margins on a specific project or on a company-wide basis.

In addition, the use of company credit cards can lead to unexpected consequences on federal projects. For instance, if employees are permitted to use the cards for personal or unallowable charges, then these amounts could be inadvertently passed on to the government even when the employee reimburses the company. Specifically, if the charges are assigned an accounting cost code that is included in calculating the rate of overhead applied to federal contracts, then the government could take the position that the overhead rate includes unallowable costs, or even assert that the contractor has submitted a false claim.

Effective oversight of allowable project expenses is critical. To ensure the appropriate use of company credit cards, CFMs and other employees should understand which specific expenses are allowable under a federal contract.

Project expenses should be reviewed prior to submission to the government or a higher-tiered contractor. Ideally, this review should be conducted by someone who can independently verify the legitimacy of the expenses. If the company allows an employee to make purchases that are personal or...
unallowable, then it should establish an accounting protocol to ensure that such charges are assigned an accounting cost code that is not included when calculating overhead rates or preparing invoices.

**Certified Payroll Applications**

Federal construction contracts often require that *Davis-Bacon Act* prevailing wage rates be paid to all covered employees. Ensuring compliance with *Davis-Bacon Act* regulations is important because a prime contractor may be held liable and subject to offset or withholding not only for its own misclassification or failure to pay *Davis-Bacon* wages, but also for its subcontractor’s or a lower-tier contractor’s failure to comply. Accordingly, third-person review of all certified payrolls is essential. The accounting department should vet payroll submissions before they are forwarded to the government or a higher-tiered subcontractor.

**The Internal Investigation**

If fraud allegations arise, then an internal investigation should commence as soon as possible. The earlier the fraud is investigated (and ultimately uncovered), the more likely a company will be able to mitigate its negative effects.

Although each investigation requires its own protocol, some categories of information should be reviewed in almost every case. If the investigation targets the conduct of an employee or several employees, the corporate e-mail accounts of these individuals may provide helpful information. Although an e-mail review may not uncover an admission of wrongdoing, it may reveal examples of additional misconduct to be investigated. A review of corporate e-mail may also uncover participation by other employees or vendors.

If the potential fraud refers to a specific project, then paper documentation for the project should be reviewed in addition to the electronic records. The paper documents may include handwritten notes or other information that is relevant to the investigation.

In addition, the company should consider conducting witness interviews to obtain any additional information regarding the fraud or misconduct. Employees who are aware of the misconduct also may have personal files with information relevant to the investigation.

Construction companies that face internal fraud allegations may want to consider hiring outside counsel to conduct the investigation. Hiring an independent third party lends credibility to the investigation if the findings are later used in a subsequent civil suit or government enforcement action.

Additionally, if the fraud is ongoing, or the alleged employees are still working for the company, it is beneficial to keep the investigation confidential. Otherwise, important files and/or evidence of the fraud might be destroyed, making any subsequent civil action more difficult to prosecute. Keeping the allegations confidential may also afford the company additional time to conduct the investigation without disrupting normal business operations.

Investigators should meticulously document all aspects of the investigation, as these records will be essential to protect the company from allegations of wrongdoing if a government investigation is initiated against the company. The extent of a contractor’s cooperation may also play a factor in determining whether suspension and or debarment is necessary. In addition, documentation will help government investigators compile a case if the company seeks to initiate a criminal investigation against the wrongdoer.

Contractors working on federal projects should also be aware of the Federal Acquisition Regulation (FAR) mandatory disclosure requirements. The FAR provides that:

...[a] Contractor shall timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed: (A) a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or (B) a violation of the civil *False Claims Act*.7

In most instances, an internal investigation must be conducted to determine whether the disclosure requirement has been triggered.

**Best Practices**

Construction companies can better detect employee fraud if they know where to look. Although every instance of employee fraud may not be preventable, the following best practices will help safeguard the vulnerable aspects of a construction company’s operations.

**Maintain a Robust Compliance System**

A company’s internal compliance system and written code of ethics should be emphasized and consistently reinforced...
to employees. For federal contractors, this internal code of ethics and conduct should, at a minimum, meet the FAR requirements. The goal is to create a culture of honesty and openness that encourages employees to report concerns about wrongdoing. An internal hotline that allows employees to anonymously report any allegations of fraud should be set up.

Generally, the FAR requires that federal contractors maintain an internal compliance system that shall “(A) Establish standards and procedures to facilitate timely discovery of improper conduct in connection with government contracts; and (B) Ensure that corrective measures are promptly instituted and carried out.”

In addition, the internal compliance system should:

- Assign responsibility for administration of the compliance system at a sufficiently high level
- Dedicate adequate resources to ensure the program’s effectiveness
- Establish a policy of periodic reviews of business practices, policies, and procedures to ensure compliance with the company’s code of ethics and conduct

**Educate Employees**

Companies need to clearly communicate anti-fraud and ethics policies to all employees. Employees should receive information about the actions that constitute fraud. Legal and ethical boundaries are not always clear, and employees may unknowingly violate civil or criminal laws, which could subject the company to liability. In addition, senior employees need to know which business operations are most susceptible to fraudulent activity and understand that invoices, change orders, and certified payrolls are potential targets. The seriousness of potential penalties must be stressed.

The company should also communicate the internal safeguards it has in place. Employees need to know that business expense accounts are closely scrutinized by the accounting department for discrepancies and/or the inclusion of unallowable expenses. Full transparency regarding compliance mechanisms can deter would-be wrongdoers.

**Conclusion**

Although construction companies strive for a culture that deters fraud and misconduct, they remain vulnerable to employee fraud, which may result in financial loss and civil and criminal penalties. A robust ethics and compliance program, together with an understanding of common fraud hot spots, will help a company detect and hopefully prevent fraudulent conduct. However, if fraud or other misconduct is discovered, then construction companies must act quickly to investigate the allegations and, if necessary, disclose the investigation results to the appropriate authorities.

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**Endnotes**

1. 2012 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, p. 31. There were 47 reported cases of internal fraud in the construction industry, 17 of which (36.2%) were related to fraudulent billing.


5. 2012 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, p. 31. (12.8% of the reported construction fraud cases in the report related to “Expense Reimbursements.”)

6. FAR §222-4.

7. FAR §203-13(b)(3)(i).

8. FAR §203-13(c).

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