



DIMENSIONS

A CPA's Report to the Construction Industry

ARE YOU AT RISK?

Internal Controls Help Deter Fraud

Can your company afford to throw away \$300,000? That's what a typical case of fraud in the construction industry costs the company that is victimized.

Every two years, the Association of Certified Fraud Examiners (ACFE) issues a Report to the Nations on occupational or internal fraud — schemes such as embezzlement, misappropriation of funds, phony expenses, bribes, and kickbacks. The most recent 2012 report shows the construction industry remains at risk for larger than average fraud losses.

While industries such as financial services, manufacturing and health care reported larger total numbers of fraud cases in the 2012 study, the construction industry outranked them in terms of the average size of loss. At \$300,000, the median loss in construction industry fraud cases was more than twice the median loss for fraud cases overall.

While it is impossible to completely eliminate the threat of internal fraud, a responsible contractor should recognize the most likely fraud scenarios and take steps to mitigate the risk.

Common Fraud Schemes

Occupational fraud can take many forms, and construction companies are vulnerable to just about all of them. In the 2012 ACFE report, billing-related schemes accounted for more than 36 percent of construction industry fraud cases. Examples include payments to shell companies, vendor fraud (often with an insider's help) and charging personal purchases to company accounts.

Construction-related businesses are particularly susceptible to another common type of fraud — theft of materials. Most work is performed at remote sites away from company headquarters, so management oversight is less consistent. Moreover, many of the materials used — such as lumber, concrete, copper pipe, wire and cable, and topsoil and fill — can be

difficult to identify and track to a specific job, making it easy to divert materials to other purposes.

A related risk involves the misappropriation of equipment. An example would be employees who operate side businesses using their employer's supposedly idle equipment.

On a larger scale, contractors are at significant risk from bid rigging schemes and related forms of corruption. Other common fraud schemes include payroll fraud involving phantom employees, as well as garden variety frauds such as check tampering and phony expense reimbursement schemes.

Effective Internal Controls

No system of internal controls is foolproof, but effective internal controls can minimize the opportunities for fraud and deter all but the most determined thief. (See "Breaking the Fraud Triangle" on page 4.)

One of the most fundamental internal controls is also one of the simplest: segregation of duties. The person who sets up vendor accounts should not be the same person who approves payments or reconciles bank statements, and the payroll clerk should not be the same person who disburses paychecks. This principle applies across all aspects of the business, and can be implemented immediately at little or no cost.

Here are some other simple yet effective internal controls you can implement with relative ease:

- Personally check all estimates for accuracy of calculations, labor rates and correspondence with drawings.
- Compare job cost estimates with actual costs. Require approvals for cost adjustments or transfers of costs between jobs.
- Require that materials estimates above a specified amount include quotes from two or more vendors.

Managing Risks During Recovery, cont.

- Make purchases only with pre-numbered purchase orders, and match them to both receiving reports and invoices before payment is made.
- Check vendor invoices against estimates to ensure proper discounts and pricing.
- Always refer to specific job numbers, phase codes or work order numbers in onsite communications.
- Obtain ink or electronic signatures on change orders before work begins, and revise contract values accordingly.
- Record equipment usage weekly. Assign and expense maintenance costs as they occur.
- Review all billings for timeliness, accuracy, conformity with contract terms, and correct customer information.
- Reconcile billings with general ledgers monthly, and document underbillings and overbillings.
- Prepare financial statements monthly and support them with ledgers, bank statements and loan schedules.

Getting Started

The majority of contractors are small businesses that cannot afford to maintain a dedicated internal audit function, but there are other practical, cost-effective steps you can take to deter fraud. Your Mueller Prost advisor can help you set up effective internal controls and test the controls you already have in place.

Please call your Mueller Prost advisor at 314.862.2070 for a review of your internal controls and other strategies, including our new fraud and ethics hot-line service, for reducing fraud risk in your business.

PUNCH LIST POINTERS:

Managing the Closeout Process

When a project draws to a close, a contractor's attention is often diverted. After all, there's other work to be done, and supervisors are needed on other sites.

But the last stages of a job require special management attention. For one thing, your retainage — which generally amounts to most or all of your profit — is at stake. What's more, when an owner takes occupancy of a building where construction materials, workers and equipment are still on site, the goodwill that was built up over many months can quickly dissipate.

In view of all that's on the line, it's prudent to periodically step back and objectively review the practices and procedures you employ for managing the final phases of a project.

The Beginning of the End

The job closeout process is generally understood to commence when the contractor notifies the owner of "substantial completion." The mechanics of this notice will vary from one contract to another. It is important to review and adhere to any specific

contract requirements regarding notification and the process to be followed.

Regardless of how it is conveyed, substantial completion should be declared when the remaining costs and risks of the project are insignificant — a common rule of thumb is less than one percent of the total contract value. It is important to approach this decision consistently, so that you can accurately evaluate performance from one project to the next.

Notifying the project owner of substantial completion generally triggers the beginning of warranty periods and changes in insurance liability, and often marks the time when the owner begins assuming responsibility for maintenance and repairs. Above all, though, it sets in motion a series of closeout events — most notably, the issuance of the punch list.

Proper attention and timely completion of punch list items will ensure the job ends on a positive note.

Managing the Closeout Process, cont.

Control the Punch List

On an ideal project, there would be no punch list because every aspect of the work was complete and perfect. In reality, of course, there are always unfinished items. The goal is to make sure the punch list contains only minor issues to be addressed before the owner accepts the work.

It is essential to guard against “scope creep” in the punch list. Likewise, the punch list should not be used to redo work that has already been accepted by the owner.

When project owners add punch list items that should rightfully be billed as change orders, contractors are often tempted to go along just to expedite the closeout and collect their final payment. This can be an expensive mistake — remember, scope creep is paid for directly out of your job profit.

Manage the Closeout Proactively

While it may be natural to view the punch list as a burden, it actually represents an opportunity to build significant customer goodwill. Proper attention and timely completion of punch list items will ensure the job ends on a positive note.

Fortunately, technology can help. Many computer and mobile applications make it easy for contractors to keep track of punch lists and completion dates accurately.

On large projects, it may also make sense to assign a dedicated administrator who is specifically charged with expediting the closeout process. This person can help arrange training and orientation for the owner's maintenance crews, and coordinate the submittal of closeout documentation, including “as-built” drawings, warranties, and operating and maintenance manuals.

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Post-Project Review

Every project of substantial size should end with an internal closed-job report and an objective review of the company's own performance. The closed-job report should include accounting for retainage billing and collection, as well as post-completion job audits to review budget variances and overruns. Actual figures collected over several jobs will help put future cost estimates and bids on firmer footing.

This is an opportunity to look back on a job to determine how profitable it was and why. By knowing the “why,” you can develop more precise and accurate bids on future jobs and, over time, focus on more profitable contracts.

Detailed closed-job reports can help you bid more effectively. Your Mueller Prost advisor can help you put them together. Give us a call at 314.862.2070.

Breaking the “Fraud Triangle”

From phony vendors to forged checks to outright theft, there seems to be no end to the ideas fraudsters can come up with. But despite their almost endless variety, all fraud schemes share three common characteristics.

These characteristics, called the “fraud triangle,” were laid out systematically back in 1953 by noted criminologist Donald Cressey in his book, *Other Peoples’ Money: A Study in the Social Psychology of Embezzlement*. This landmark work is still considered a classic guide to understanding why — and how — fraudsters take advantage of their employers.

As Cressey explained, three conditions must exist in order for a fraud scheme to develop. His fraud triangle consists of:

1. Motive (or pressure) – This could result from unexpected financial pressures such as a spouse’s layoff, medical bills or an underwater mortgage, or simply from living beyond one’s means. A less obvious type of pressure is the stress involved in meeting business goals or an employer’s expectations.

As a contractor, you have limited ability to address all of the possible motives that could trigger a fraud scheme. However, it’s important to offer fair compensation, set realistic goals, and be alert to signs that an employee is experiencing financial problems or excessive job performance stress.

2. Rationalization – In almost every instance, fraud is committed by employees who consider themselves to be honest and honorable. They do not view themselves as criminals, but have found a way to rationalize their dishonest behavior in their own minds.

When they are caught, these rationalizations can be quite revealing. One of the most common is, “It was only temporary — I was going to pay it all back.” Other common excuses are, “I had to take care of my family first,” “The company owes it to me anyway,” and “Everyone else is even more dishonest.”

Again, as an employer, there are limits to what you can do to combat this thinking. The most important step is to set the right tone from the top. Insist on

ethical treatment at all levels, and make it clear that you are committed to always treating clients, vendors and employees honestly and fairly.

3. Opportunity – Regardless of motives and internal rationalization, a fraud scheme cannot begin until a fraudster sees an opportunity to get away with it. This third side of the triangle is where you, as an employer, have the greatest ability to deter fraud.

Begin by establishing a strong system of internal controls that includes segregation of duties, multiple approvals for transactions, and numbering and crosschecking of all financial documents (see page 1 lead article for more details). An involved, hands-on management approach is also important. This can become more difficult as a business grows, but it is essential that no invoice is paid without multiple approvals, receipts are checked against bank deposits, and all transactions are crosschecked and reviewed by different employees.

As Cressey pointed out 60 years ago, a fraud scheme can develop only if all three sides of the triangle are present. By focusing on those areas of the triangle where you have the greatest influence, you can reduce — but not completely eliminate — the risk of fraud losses in your company.



Call Adam Herman at 314.862.2070 today to find out about our expanded Fraud and Forensics service offerings including our new fraud and ethics hot-line service!

Finding and Keeping Qualified Employees

After prolonged layoffs, many workers apparently abandoned construction to work in other industries.

According to a September 2013 survey by the Associated General Contractors of America, 74 percent of construction firms are having trouble finding qualified craft workers, and 53 percent report difficulty filling professional positions such as project supervisors, estimators, and engineers.

What's more, 86 percent of those surveyed expect it will remain difficult to find qualified craft workers during the coming 12 months.

Here are seven ideas that can help you attract and retain quality construction employees:

- 1.** Offer a compensation package that's competitive — not just within the construction industry, but also with other industries using similar skills.
- 2.** Provide employees with a summary listing the dollar value of all benefits received including wages, Social Security and Medicare contributions, other health and retirement benefits, meals, mileage and other reimbursements.
- 3.** Provide cross-training or multi-skill training. In addition to improving worker satisfaction, this can give you more flexibility with future staffing problems.
- 4.** Make safety a priority. A strong safety program not only helps you avoid fines, liability and downtime, it also lets employees know you value their welfare.
- 5.** Provide good working conditions, including well-organized worksites, properly functioning equipment, adequate rest periods, comfortable working spaces and fair treatment.
- 6.** Establish a system of regular communication and feedback. Today's skilled worker is very concerned about future growth opportunities.
- 7.** Be proactive in recruiting and hiring (e.g., mentoring programs, internships, career fairs and construction skills academies).

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The firm offers a full range of professional tax, audit, accounting and management advisory services to the construction industry.

For more information, please contact **Ralph E. Crancer, CPA** at 314.862.2070 or rcrancer@muellerprost.com.

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