PKF
Certified Public Accountants

Dimensions

A CPA's Report for the Construction Industry

Fall 2018

Fighting Fraud

Study Shows Controls Can Reduce Losses

None of us like to think that our own employees could steal from the company, but the risk of fraud is an unfortunate fact of life for any contractor.

According to a newly released study by the Association of Certified Fraud Examiners (ACFE), among all the various types of fraud your company might encounter, the "largest and most prevalent threat" comes from occupational or internal fraud—that is, fraud committed by your own employees or managers.

Every two years the ACFE issues its "Report to the Nations" on internal fraud schemes such as embezzlement, misappropriation of funds, phony expenses, bribes, and kickbacks. Based on information that CFEs report from real fraud cases around the world, the study is widely regarded as the most comprehensive source of occupational fraud data.

The new report shows that the construction industry remains at risk for larger-than-average losses from such schemes. In the 2018 survey, the median loss from cases in the construction industry was $227,000. That's down slightly from earlier years but still large enough to do serious financial damage to almost any contractor or subcontractor.

Reducing Fraud Losses

While it is impossible to eliminate the threat of internal fraud, the ACFE study found that the median losses in companies with strong anti-fraud controls is considerably lower than the losses in companies without such controls.

For example, when comparing fraud losses across companies in all industries, the study found the median loss in companies where there was a written code of conduct was $110,000, while the median loss among companies without such a code was $250,000.

Likewise, the median loss in companies that conducted surprise audits or management reviews was half the size of the median loss in companies that did not engage in such practices. There was a similar reduction in median losses among companies that had anti-fraud hotlines in place.

While such controls might not prevent fraud altogether, they can help uncover fraud schemes earlier and thus keep the losses from continuing to grow over an extended period. The sooner the fraud is detected, the sooner the bleeding can be stopped.

Common Fraud Schemes

Occupational fraud can take many forms, and construction companies are vulnerable to just about all of them. Corruption cases such as bid-rigging and bribery were the leading types of reported fraud among construction businesses in the 2018 report, accounting for 42 percent of reported cases. Billing-related schemes—such as payments to shell companies or vendor fraud with insider help—ran a close second, accounting for 37 percent of construction industry cases.

Construction businesses are particularly susceptible to another common type of fraud—material theft. Most work is performed at remote sites away from company headquarters. Moreover, materials such as lumber, concrete, copper pipe, wire, and cable can be difficult to identify and track to a specific job, making it easy to divert them to other purposes.

A related risk involves the misappropriation of equipment. An example

Continued on page 3

Understanding the Basics of the Job Schedule

This is the first in a series of articles about the job schedule, including the work-in-progress (WIP) and contracts completed reports, which are critical components of contractors' financial statements.

If your company needs to submit financial statements for bonding, you typically are required to include a list of all jobs open at the end of the reporting period, along with a list of jobs closed during the period. This job schedule is a necessary supporting document for any company that uses the percentage-of-completion (PoC) method of accounting for recognizing revenues on long-term contracts—as most construction businesses do.

The job schedule is an essential tool that helps sureties, lenders, and other interested parties assess your company's financial performance and management capabilities. It also can serve as a valuable tool to help owners and managers do a better job of assessing and improving the company's performance.

WIP Fundamentals—What, Who, and Why

The WIP report lists all projects that are still in progress as of the closing date of the financial statement. The schedule displays the relevant financial data for each project including the total estimated revenues and costs, the actual billings and costs incurred since the project's inception, and the billings and costs incurred during the reporting period.

In addition to tracking the costs and expected profit margins associated with each job, sureties and other users look to the WIP schedule to track over- and under-billings. The schedule typically identifies these as "Billings in Excess of Costs" and "Costs in Excess of Billings."

Under the PoC method, over-billing occurs when the percentage of a project's expected revenue that has been billed to date exceeds the percentage of the expected costs that have been incurred. Analysts regard this as a sign that your company is managing its billings actively and staying ahead of costs.

On the other hand, under-billing occurs when the percentage of project costs that have been incurred so far is higher than the percentage of expected revenues that have been billed. Most sureties regard this as an early warning of possible profit fade and cash flow problems in the near future. Consistent under-billings can also lead the surety to question your company's ability to estimate jobs accurately, which ultimately can lead to a further reduction in bonding capacity.

Which Jobs Should Be Listed?

One area that sometimes causes confusion when compiling the job schedule is the question of which projects should be listed. In their desire to be complete and open, contractors sometimes list work that should not be included on the job schedule.

Among the projects that should not be included are management-only projects—that is, projects for which your company is collecting a project management fee only and is not incurring direct project costs or liabilities such as material purchases or subcontractor fees. Such projects do generate salary costs and administrative expenses, but these typically are billed as the services are delivered—so there's no substantial variation between billings and revenue recognition.

Likewise, ongoing maintenance or service contracts should not be listed on the job schedule. This is true even if the service contract is a long-term agreement that covers more than one reporting period.

In general, any project for which the PoC method is applied should be included on the job schedule. Here's another common rule of thumb: if a project is performed in phases, that generally is a sign it should be on the job schedule.

The distinction between fee-based projects and long-term contracts is not always clear, however. So plan to work closely with your accounting professional to ensure that all appropriate jobs are listed—and those that are not are excluded.

For more information on the WIP schedule and other financial statements, please call us for an appointment.

The next article in this series will examine the importance of realistic and accurate estimates of project timelines and costs.

Effective Internal Controls

Reducing Losses, Managing Risks

No fraud prevention program is foolproof, but effective internal controls can minimize the opportunities for fraud and lead to earlier detection of fraud schemes.

One of the strongest and 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 almost immediately—usually at little or no cost.

Here are some other simple and practical internal controls you can implement with relative ease:

- Check all estimates for accurate 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 material estimates above a specified amount include quotes from two or more vendors.
- Make all purchases using prenumbered purchase orders. 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, and consistently assign and expense maintenance costs as they occur.
- Review all billing for timeliness, accuracy, conformity with contract terms, and correct customer information.
- Reconcile billing with general ledgers monthly. Fully document under- and over-billings.
- Prepare financial statements regularly, and support them with ledgers, bank statements, and loan schedules.

Please call us to schedule a review of your internal controls and to discuss any needed enhancements.

Fighting Fraud

Continued from page 1

would be employees who operate side businesses using their employer's supposedly idle equipment.

Breaking the "Fraud Triangle"

Despite the almost-endless variety of schemes that fraudsters devise, all fraud incidents share three common characteristics. Criminologist Donald Cressey identified these in his landmark 1953 book, *Other Peoples' Money: A Study in the Social Psychology of Embezzlement.*

As Cressey explained, three conditions must exist for a fraud scheme to develop. These conditions are sometimes referred to as the "Fraud Triangle":

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

2. Rationalization—Most employees who commit fraud do not view themselves as criminals. In fact, most consider themselves to be honest and honorable, and have found a way to rationalize their dishonest behavior. Often, they tell themselves that their theft is only temporary and that they'll pay it back or that the company owes it to them anyway.

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 is where you, as an employer, have the greatest ability to deter fraud by establishing a strong system of internal controls. (See the article, "Reducing Losses, Managing Risks" on this page.)

It's also important that company management sets the right tone from the top. Make it clear you are committed to ethical behavior—always treating clients, vendors, and employees honestly and fairly.

We would be happy to discuss additional strategies for reducing fraud risk. Please call us for an appointment.

PKF
Certified Public Accountants

99 Summer Street, Suite 1660
Boston, MA 02110
617-PKF-9985

300 Crown Colony Drive, Suite 400
Quincy, MA 02169
617-422-0007

www.pkfboston.com

Get an Early Start on Your 2018 Income Taxes

Because of the sweeping changes in the 2017 Tax Cuts and Jobs Act, it's especially important to get an early start on both your business and personal tax returns this year. Many commonly used tax forms will look very different from previous years, many others have been eliminated altogether, and there are a number of new schedules and supporting documents.

For example, over the summer the IRS released a draft version of the 2018 Form 1040. Obviously, most of us don't file paper tax returns anymore, yet the paper Form 1040 serves as the basis for all the various software programs we use to file electronically. So, its changes give us some idea of what to expect this year.

The new Form 1040 is only about half the size of last year's form—close to postcard size. In addition, the IRS has eliminated the Form 1040A and Form 1040EZ—all 150 million U.S. individual taxpayers will now use the basic Form 1040.

While the new Form 1040 eliminates about 50 lines of information from previous years' forms, it introduces a half dozen new supporting schedules to gather that information and make calculations.

The IRS notes that it has not yet finalized the draft Form 1040, and it expects to make more changes before it's done. In addition, many existing schedules are still being revised to reflect the new tax law.

Of course, the agency must also update its entire portfolio of business tax forms for corporations, partnerships, and various pass-through entities. Most of these will also see substantial revisions by the time they're released.

Please call us if you have any questions about this year's many tax law changes or to get a head start on the upcoming filing season.