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Re: Combatting Fraud in Construction Companies in Alberta

Date: June 11, 2014

Combatting Fraud in the Construction Industry in Alberta

Final Paper – Assignment # 4

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June 11, 2014

I hereby certify that the following piece of work complies with the MacEwan University Academic Integrity Policy relating to plagiarism and fabrication and falsification as listed in the Academic Integrity Policy C1000.

Executive Summary

- **Purpose of the Report**

The purpose of this report is to present the primary and secondary research findings garnered in the examination of fraud in the Alberta construction industry. The methods used included interviewing Judi Nordstrom, Project Manager and mentor at Williams Scotsman of Canada Inc., as well as the interview with Shweta Pejavar, the human resources manager at WestRich Pacific, a home-building company in Edmonton. In particular, the report presents the findings which are centered on identifying the causes of fraud in the construction industry, dispelling the myths which abound relating to fraud, and offering solutions on what should be done to combat the problem.

- **Significant Headings**

1. The role of internal audit in preventing fraud
2. Six main causes of cost and schedule overruns
3. Identifying perpetrators of fraud
4. Importance of allocating individual responsibility for fraudulent activity
5. Government involvement in construction industry fraud
6. Integration of accountants and engineers in the struggle against fraud

- **Conclusions of the Report**

The findings of the report indicate that fraud is profoundly misunderstood and influenced by the reports of the media, which often does not utilize information provided by academically

acclaimed articles, focusing instead of appealing to the masses, as was indicated by the widespread coverage of the Enron and WorldCom scandals of the early 2000s. The image created by the media when relating to fraud is that of a highly complex scheme organized at the highest organizational levels of a corporation. The research provided on this topic demonstrates that accounting fraud must be examined in a manner that seeks to single out the individual guilty parties, in order to prevent the collective from suffering from the actions of a few bad apples. By approaching the problem of fraud in this manner, the business world can hope to achieve a greater sense of individual responsibility and commitment to ethical behavior in terms of accounting and financial reporting in the construction industry. Due to the fact that the construction industry is heavily dependent on the expertise of engineers, cooperation between accountants and engineers is of paramount importance. Internal audit can thus serve a more purposeful struggle against fraud by having the knowledge, resources, and expertise of accountants and engineers at its disposal. As the construction industry operates on the basis of contracts between companies or between the government and a contractor company, the issue of cost and schedule overruns is of vital importance in detecting overstated and exaggerated costs, which is a rampant problem in the Alberta construction industry and as such constitutes the vast bulk of fraudulent activity.

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Research Questions:

- 1.) What constitutes accounting fraud?
- 2.) Should new legislation be drafted to combat accounting fraud or should existing legislation be implemented more effectively?
- 3.) Who should carry out audit services in construction companies in Alberta?
- 4.) Why is the construction industry in particular vulnerable to accounting fraud?
- 5.) How does accounting fraud correlate with cost overruns in construction projects?
- 6.) Who is affected by accounting fraud in the Albertan construction industry?
- 7.) What is role does government play in engaging in, as well as detecting accounting fraud?

Introduction

The Alberta construction industry employs a vast number of Albertans and forms the backbone of the Albertan economy. The construction industry itself is closely related to the oil and gas industry in Alberta, as the success of the latter typically signals prosperity in the former. Their mutual success depends upon success of the other. The Alberta construction industry is responsible for building roads and bridges which enable the transport of workers and resources which makes the success of the oil and gas industry possible. It most importantly is responsible for building homes and office spaces in Alberta, without which the population influx of workers into Alberta would not be possible. Therefore, the construction industry in Alberta is a central foundation of the continuous economic success of the province which renders it necessary to ensure that it functions optimally and in an ethical manner.

Fraud is a major problem in the construction industry in Alberta and is the cause of fiscal inefficiency and lost revenue for corporations and government alike. Furthermore, fraud wrongfully deprives the tax payers of public funds as well as ensuring that public funds are not used to their optimal potential, leading to a lower than possible quality of public construction projects. Therefore, it is important that fraud in the construction industry be combatted through the joint efforts of accounting professionals, engineers, government, judicial regulation, and public awareness alike, with the goal of achieving a progressive public consciousness that accepts individual and collective responsibility of all individuals of society for the problem of fraud in the Alberta construction industry. Fostering a public dedication to a fraud-free environment in the Albertan construction industry should be the long term goal of the province and towards that noble cause this research is dedicated.

Body of Report

Accounting fraud is defined as “deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.” (Agarwal & Medury, Page 7) The key word is deliberate, which indicates that fraud is a calculated attempt to obtain material gain through manipulation and violation of public interests. In simple terms, fraud is a highly technical and specialized form of theft. Although there is temptation to view fraud as a white-collar crime, this is a very limited view, especially in the Alberta construction industry. This industry is comprised of a great number of blue collar workers and contractors, which ensures that fraud is both a blue collar and white collar problem. The deliberate nature of fraud differentiates it from genuine accounting errors caused by human imperfection. With the intention of finding out more about fraud in the Alberta construction industry, particularly in the sphere of home building, an interview was conducted with Shweta Pejavar of Westrich Pacific, whose role of human resource manager renders her an authoritative resource on fraud, its detection, and the management of human factors which contribute to the problem.

Interview with Shweta Pejavar:

The interview with Shweta Pejavar, Human Resource Manager for Westrich Pacific, an Edmonton home builder, yielded some highly valuable insight into construction industry fraudulence.

- 1.) What are the primary causes of the alarming scale of accounting fraud in Albertan residential and corporate construction industries? (This addresses research question 4.)

Answer: In my experience from the Human Resources side, I find that a lot of contractors do not have basic understanding of ethical principles in accounting and have a

rather old-school mentality, where anything goes so long as you can get away with it. The blue collar workers do not understand the importance of ethical representation of information for the most part because they lack the necessary training and understanding of accounting.

- 2.) How can the various demographic elements which are moving to Alberta for work be made aware of the importance of integrity in accounting-based reporting within Albertan construction industries? (This addresses research question 2.)

Answer: Alberta has an ongoing population influx which I can attest to because our company cannot build houses fast enough to sell to customers. Those customers are coming here to work and a lot of them are working in the construction industry. The difficulty is in educating the highly varied demographic of people moving here due to a lack of procedures in construction companies for the purpose of educating the workers. Except for accountants, human resource staff, and executive management, the others are largely in the dark because there are no programs in place to educate the people moving to Alberta to work in the construction industry. My suggestion is that accounting-based ethics programs need to be developed in each construction company and this should be required by provincial legislation. This way, even the blue collar labourer will be made aware of basic ethical accounting principles and of their importance.

- 3.) Should ongoing legislation development by the Albertan government seek to target smaller perpetrators of white collar fraud in Alberta construction industries or should they

concentrate on holding entire corporations responsible through large scale civil action lawsuits? (This is addressing research questions 2 and 7.)

Answer: As I have already mentioned, I believe that legislation is key, but it should seek to educate rather than punish, as punishment is a reaction which doesn't eliminate the harm caused by fraud, while education is preemptive action that eliminates the problem before it starts. So I believe that legislation should seek more to institute required accounting ethics programs in companies, rather than to target white or blue collar perpetrators of fraud in the construction industry.

- 4.) How should new legislation be developed in order to curb accounting reporting fraud in small construction contractor businesses? (This is addressing research question 2.)

Answer: The new legislation should be pragmatic and specialized. Legislation requiring, for example, a home builder to institute accounting ethics education programs needs to address the particularities of that industry, which is definitely different from the legislation that would institute accounting ethics education programs in the modular office space industry where you work. This is necessary in order for it to be more effective in developing a understanding of accounting ethics in the workers of each particular segment of the Alberta construction industry.

- 5.) In terms of the modular building industry, would the introduction of internal auditors facilitate the reduction of fraudulent reporting, or should all employees be required to take a crash course in accounting ethics, and business ethics overall? (This is addressing research question 3.)

Answer: Internal auditors are an excellent idea, but an expensive one. Nevertheless I believe that it is important for internal auditors to be incorporated, not just in the modular building industry, but in all sectors of the Alberta construction industry. But I don't think that it is enough, as internal auditors will only detect fraud after it happens. It is important that all employees take some form of ethical training in terms of accounting, in order for those internal auditors' reports to show positive results in decreased fraudulent activity.

- 6.) What role would Human Resource managers have in working with accounting managers to develop anti-fraud mechanisms within their respective organizations? (This is addressing research question 3.)

Answer: My role as human resource manager is heavily involved in investigation and conflict management. It is my job to communicate effectively the changes that occur in the company and make sure that all employees know what the changes are and what is expected of them. Therefore, the role of the human resource managers will be to help accounting managers develop the most engaging anti-fraud mechanisms which the employees will understand and take ownership of. Our role is to provide a communication link between the employees and the accounting professionals in the company who develop the anti-fraud mechanisms.

- 7.) From a Human Resource standpoint, who, in your professional opinion, is most severely affected by accounting fraud in the Albertan construction industry? (This is addressing research question 6.)

Answer: The company and its financial stability is what suffers the most, definitely.

Also, bear in mind that any public knowledge of fraud occurring in a corporation is a public relations nightmare and can damage a company's reputation over a longer period of time.

The interview with Shweta Pejavar offered unique insight into the viewpoints of a human resource manager of a construction firm in Alberta and proposed specialized solutions to the problem of fraud. Miss Pejavar's tenure as a human resource manager ensures that her proposed strategies are tailored towards engaging the employees in the most effective manner. In order to find answers to the problem of fraud which address operational issues, an additional interview was conducted with Judi Nordstrom, Project Manager, Project Coordinator Supervisor and this author's mentor at Williams Scotsman of Canada Inc.

Interview Questions:

- 1.) Judi, as a Project Manager with extensive experience, you have managed innumerable high-cost projects, involving frequent financial overruns. My question is if you feel that cost overruns in construction projects are caused by accounting fraud, and if so, what percentage of the time? (This is addressing research question 5.)

Answer: Generally speaking, we mark-up products and services at a rate that falls between 25% to 35%. It is an unwritten understanding between the various construction and industrial businesses in Alberta that such markups of services and products are acceptable and expected. After all we are all trying to earn a living. If discounts are offered, they are usually due to a failure to deliver a product or service on time, and in

that instance, a markup will be in the mid-teens percentage wise. One thing to keep in mind that what sometimes unfortunately occurs is what I call punitive pricing. When dealing with a particularly difficult client or customer who has caused a lot of headache and general trouble for a company's staff, especially the project managers and budget controllers, I have witnessed that those customers often receive quotes and prices where markups are well above 35%. I dislike this practice and I opposed its application in any projects I managed but I have seen this practice on a fairly widespread basis. I see it as accounting fraud, because marking up services to that extent represent an attempt to profit unfairly.

- 2.) Given the unpredictable nature of field operations and the high turnover rate of employees, how should management ensure that accounting rules are adhered to and that ethical standards are upheld, in particular by the field contractors and their management? (This is addressing research question 2.)

Answer: I propose a double strategy. First, it is essential to have a mandatory process in which ethical training is made compulsory for all new employees as well as field contractors who wish to work for the company. Secondly, I believe that project managers in charge of supervising field operations should have punitive powers. Let me explain, I believe that a project manager should have a lot more power to investigate what contractors are doing and to actually propose punitive measures. At the present moment, the project manager can investigate actions in the field, but it is up to the executive management to devise disciplinary measures. Those executives are often not in touch with what is going on in the field to the same extent as a project manager who goes out

into the field. The power to engage in disciplinary measures should be decentralized and more of this power should be given to project managers, who would in turn consult with colleagues in the accounting department as to whether an action that a contractor undertook constitutes as fraud or not.

- 3.) In your own words, as a project manager, what does accounting fraud mean to you, from a purely construction project manager point of view? (This is addressing research question 1.)

Answer: Accounting fraud means that a job will be done inadequately, poorly, and with substandard quality. Quality is key to success in the construction industry, because lack of it leads to situations in which repeat work must be done to rectify problems. For example, if corners are cut by a contractor, who is charging us double what the material necessary for completion of a job costs, those extra funds lost to fraud will ensure that we will need to cut costs somewhere else which may affect overall quality. Fraud is theft that has far reaching consequences.

- 4.) Judi, do you feel that government legislation regarding construction contractors is too lax in Alberta, or do you feel that implementation of the legislation is the bigger problem? (This is addressing research questions 2 and 7.)

Answer: Quite honestly, I feel that the government legislation in Alberta is inadequate in addressing the problem, partially because there is such a high need for skilled tradespeople in Alberta, and the government legislation simply cannot keep up, in my opinion, with the ever-increasing need for contractor work. I feel that they are too willing

to look the other way in many cases with instituting new legislation to regulate contractors, due to such pressure caused on the Albertan construction industry by this bottleneck.

- 5.) As a project manager with over two decades of experience, I am interested to hear, in your professional opinion, what you feel are the three main reasons why the construction industry in Alberta is so vulnerable to accounting fraud? (This is addressing research question 4.)

Answer: The shortage of skilled tradespeople is key and our province needs to train more skilled tradespeople in order to reduce this bottleneck. Those contractors who are skilled have more work than they can ever complete and can therefore act with a lot of self-assurance. They can charge outrageous markups for example. They can overstate the time required for them to complete their work, which touches on the earlier topic of cost overruns. The three main reasons why the construction industry in Alberta is so vulnerable to accounting fraud are lack of skilled tradespeople, lack of effective legislation that regulates how they charge customers for services rendered, and the lack of a standardized range of markup for services.

- 6.) Who do you feel suffers more as a result of accounting fraud in Albertan construction industry, government, construction companies, or the tax payers? (This addresses research question 6.)

Answer: In my experience, the company suffers the most. In business, reputation is everything, and when fraud occurs, the company gains a bad name. Even if the guilty

individual is identified, the company's image is still tainted. A company stands the most to lose from corruption and fraud, as its business image directly influences the profitability of the company's business operations.

The interview with Judi Nordstrom indicated that fraud leads to low quality work being done by a construction company. She also reveals that the problem is in the fact that such a high shortage of skilled tradespeople working as contractors ensure that the ones who are working are in a position of power to dictate their prices at free will and often to unreasonable extremes. She indicated that the accepted markup range falls between 25% to 35%, which is the practice between Williams Scotsman of Canada Inc. and its vendors. However, this author himself can attest to having been presented with outrageous charges by contractors for inadequate work. In one instance, a contractor charged Williams Scotsman for sending a crew of four carpenters to a site north of Fort McMurray to complete a modular office building installation. The contractors did not have adequate drug and alcohol testing certification and were denied access to the site. However, the bill was emailed which charged \$50 per hour for each of the four carpenters for the time travelled, in addition to charging a truck fee, a \$1 per kilometer, as well as four separate hotel rooms for the four carpenters. Charging Williams Scotsman in a manner where travel is represented as work, especially since it was the fault of the contractors that they did not have satisfactory drug and alcohol testing certification complete, is grossly unethical, as is charging the company for four separate rooms, when the carpenters could have easily chosen to rent two rooms with two beds each. This experience perhaps best illustrates unethical behavior by contractors in the Albertan construction industry, which is enabled by the fact that refusing to

pay them will ensure that the company is left without a contractor, a rather scarce commodity in the province.

Professor George Jergeas illustrated in his article “Analysis of the Front-End Loading of Alberta Mega Oil Sands Projects” that there are six main causes of cost and schedule overruns. They are: “unrealistic or overly optimistic original AFE cost estimate and schedules, incomplete scope definition or inadequate front-end loading and poorly completed front-end deliverables including milestone schedule slippage in front end, inappropriate project strategies for the mega oil sands environment, mismanagement of the construction phase, front-end loading, and measurement of engineering effort” (Jergeas, Pages 5 – 6) Unfairly high markups fall into the realm of the mentioned “unrealistic or overly optimistic original AFE cost estimate” (Jergeas, Pages 5 – 6) and constitute a common component of accounting fraud in the Alberta construction industry.

The widely held belief that fraud is something that is perpetrated by large corporations is popular since the Enron and WorldCom scandals of the early 2000s. The tendency is to blame corporations’ drive for profit as the problem behind why fraud occurs. However, according to the Grant Thornton article “Construction Fraud in Canada – Understand It, Prevent It, Detect It”, this is not the case. “In many cases, rather than the stereotype of construction companies defrauding individuals or the public, it is the companies themselves losing money to fraud perpetrated by employees, contractors, subcontractors, and venture partners” (Malamed, Mocherniak & Hillyard, Page 3) Rather than fraud being a large scale, highly coordinated scheme operating from the highest executive levels downward, fraud is often the work of individuals or groups limited in size.

Public construction works in Alberta, in particular those which pertain to road construction are based upon “significant one-off, long term contracts, often for the public sector, using complex supply chain.” (Hook, Morris, Goetjen, Etzold, Page 3) The importance of maintaining integrity and ethical accountability in public construction projects is especially important due to the fact that tax payers’ funds are used towards completion of the projects. As such, it is necessary to prevent long term contracts from lagging and falling behind expected completion dates. If such occurrences exist, financial penalties for tardiness are necessary, in order to prevent the companies from charging for extra time allocated towards completing a project. In this instance, individual responsibility is again revealed to be important, due to the fact that an entire company should not be affected by the fraud perpetrated by certain members of that company. For example, if a company is late in completing a public road construction project due to perpetual and intended delays, investigations need to be conducted into what segment of the company team is responsible for the delay. Subsequently, inquiries need be made into whether the allocated resources are being used effectively and fairly.

The government must be involved in developing anti-fraud solutions in a fair, unbiased, and responsible manner. The obvious problem of the dilapidated state of Albertan roads every spring brings to mind the question of whether or not the government is doing enough to ensure that the quality of work being done by the road construction companies is at an acceptable level or whether it is sub-standard. The suspicion that road construction companies are building roads that will break in a year and require subsequent repairs by those same companies cannot be overlooked. Due to the fact that the provincial government is involved in procuring and awarding contracts to road construction companies, the government must ensure that those contracts are not being abused and that tax payer funds are not being misappropriated. In his article

“Municipal Best Practices: Preventing Fraud, Bribery, and Corruption”, Anderson highlighted that the problem of fraud is exemplified not only by the perpetrators but likewise by the lack of effective government action. Thus, it is necessary for the provincial government to be far more scrutinizing in examining the existing contracts as well as the scope of the future contracts which are procured, in order to prevent construction companies from engaging in fraudulent practices of building products that break, with the intention of creating work for themselves at a future date.

Conclusively, the importance of incorporating the expertise of accountants and engineers is demonstrated in Lazarczyk’s “Project Audit – Joint Engineer and Accountant Team Approach”. While accountants understand the financial scope of operations, they do not possess the technical understanding of operations; simultaneously, engineers are experts in operations and the work carried out by operations, but lack the profound background in financial management and accounting principles in order to enforce them in the field. Therefore, it is necessary for accountants and engineers to work together in a unified team, with the purpose of bridging the knowledge and expertise of these two disparate areas to create a corporate environment in which the scope of work of operations is profoundly understood and the accounting/financial aspect therein is controlled and managed most efficiently. In this manner, perpetrators of fraud will not be able to effectively engage in their intended activities, due to the high likelihood of detection of a project control team composed of both engineers and accountants.

Conclusion:

Fraud deprives the tax payers of their funds, tarnishes the images of corporations as well as their ability to generate profits, and cripples the effectiveness of elected government. When viewed on a macroscopic scale, fraud cripples economy and democratic institutions, due to their failure to serve the interests of the public in the most ethical manner. The seemingly endless expansion in construction projects in the province of Alberta will ensure that a pressing need for investigation of fraud, and the development of effective anti-fraud strategies will continue to increase. Government legislation must follow in step and remain relevant and up to date. It is important for corporations to foster a sense of individual adherence to responsibility and accountability towards ethical accounting practices. The goal of the construction industry in Alberta must therefore be to foster a long-term development of a consciousness, whose goal it is to create a society in which fraud is outcast and rejected by the wider corporate circles, as well as professionals and contractors alike. The economic and human benefits will prove to be immensely rewarding and will justify the struggle to combat fraud in the Alberta construction industry.

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