

Economic Crime in the Construction Industry

We are delighted to present this companion piece to the Global Economic Crime Survey 2003, which was based on interviews with executives responsible for detecting fraud in over 3,600 companies in 50 countries. In this construction supplement, we take a closer look at results for companies in the industry and examine in greater detail issues, which may be of particular importance to construction companies. The supplement examines data from 184 construction companies in 44 countries.

We hope that this special report will help to highlight the importance of this issue to construction industry executives, stimulate discussion, and aid in the development of increasingly effective means of combating economic crime.

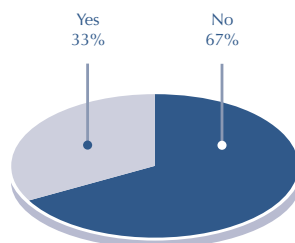
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A significant threat

Economic crime continues to be a problem for construction firms. Our survey indicates that at least one-third of construction companies worldwide were the victims of a significant fraud during the last two years. And yet, construction still appears to have a lower than global average of reported fraud – despite its reputation for incidences of asset misappropriation and corruption & bribery. Maybe it is not that the construction industry suffers less fraud; rather, it detects and reports fewer incidences than other industries. In fact, it seems clear that construction companies approach the problem of fraud in ways starkly different from companies in other, more highly-regulated sectors: one view that prevails is that if the value of the defrauded assets is less than the costs of implementing a robust fraud risk management system, it may be simpler to overlook the problem.

Percentage of construction companies reporting economic crime

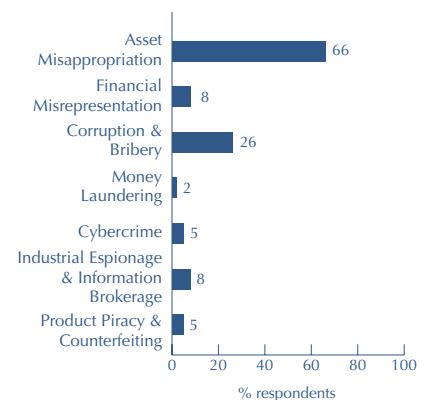


Types of fraud

The most prevalent types of fraud reported in our survey of the construction industry are asset misappropriation and corruption & bribery, which together account for two-thirds of all losses. However, while asset misappropriation is by far the easiest type of fraud to value as it involves the loss of material goods, at least one third of all firms we spoke to couldn't even begin to accurately quantify their losses.

Corruption & bribery appears to be rife and, indeed, the made-to-order nature of construction projects create many more opportunities for wrongdoing in areas such as procurement, thereby resulting in many more opportunities for bribery & corruption.

Types of economic crime affecting the construction industry



However, financial misrepresentation does not appear from the survey to have had a major impact in this sector and this may be in part due to the way profits and the values of work in progress are reported. Analysts see the inconsistency in profit reporting as one of the risks inherent in every construction project, and are rarely surprised if a company's assets are undervalued. Indeed, a greater problem facing the industry may be the tendency of contractors to overvalue contingent assets and of project owners to undervalue contingent liabilities related to unresolved claims.

Fortunately, the crimes of money laundering, product piracy and industrial espionage do not appear to significantly affect the construction industry, and there is proportionately less cybercrime because the construction industry, due to the nature of its on-site project work, possesses fewer IT networks. However, IT applications are becoming more prevalent, particularly in the US market and contractors, engineers, project managers and project owners are relying more and more on IT applications to manage project costs, schedules, budgets and performance. Whilst not yet widespread, web-based central project management systems have been

adopted by some of the more sophisticated players in the industry and the potential for cybercrime is increasing.

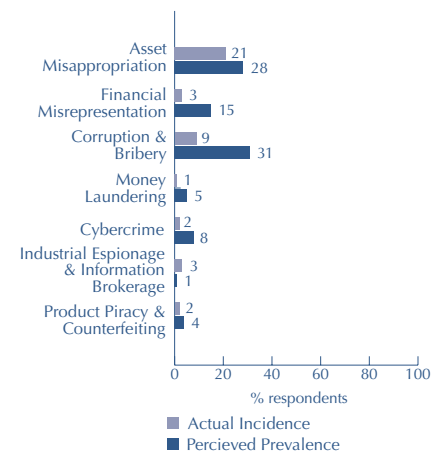
Perception is reality

While our survey showed asset misappropriation and corruption & bribery to be the most commonly reported economic crimes in the construction industry, we also found that the respondents' perception of their prevalence was even higher. In fact, among our respondents, levels of perception were three-and-a-half times higher than the number of reported incidences, and this heightened awareness may be due to the extensive media coverage of recent financial misrepresentation in other industries. However, a combination of the highly competitive nature of the construction tendering process, a lack of transparent selection criteria for many projects, increasingly tighter margins, close relationships between contractors, subcontractors and (sometimes) project owners, and the historical occurrence of "cronyism" in the industry may be a greater contributor to this perception.

We also found that while our survey subjects readily acknowledged that corruption & bribery affected their industry, few were willing to admit

that their own companies were at risk, or – because many of them simply do not have adequate means or control mechanisms to reduce the risks of project-related crimes – that they themselves may have been the victims of fraud.

Economic crimes considered most prevalent compared with their actual incidences (construction sector)



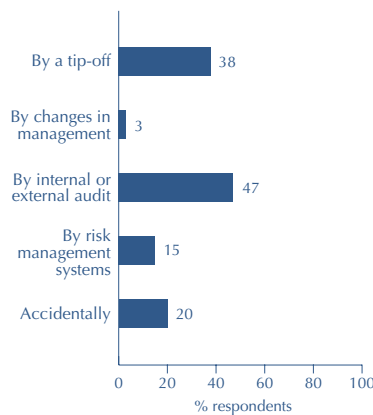


Misplaced confidence?

In spite of the high levels of fraud reported in the industry and the fact that only 15% of these cases were uncovered by risk management systems, 87% of the responding companies stated that they were confident in their existing fraud risk management programmes. However, internal and external audits seem to be the most effective means of detecting fraud, largely because audits never assume that best practices are already in place and they are therefore able to provide a level of scrutiny that is more likely to uncover fraud.

However, most fraud comes to light as the result of either a tip-off or accidental discovery. The tip-off is the most frequent source of intelligence, often because the whistleblower holds the company in high regard or, alternatively, they have personal reasons – jealousy, for instance – for turning somebody in to management. And last on our list is accidental discovery, which accounts for only one-in-five cases of frauds – which begs the question: how much is being missed by these companies?

How economic crime is detected (construction sector)



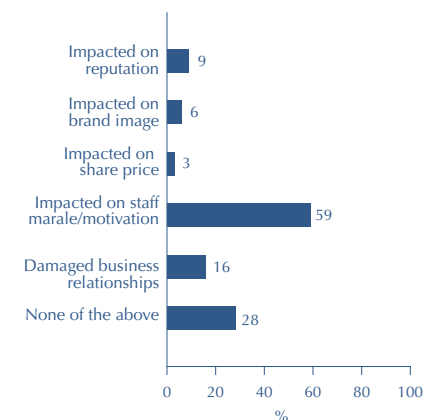
Fraud: the human cost

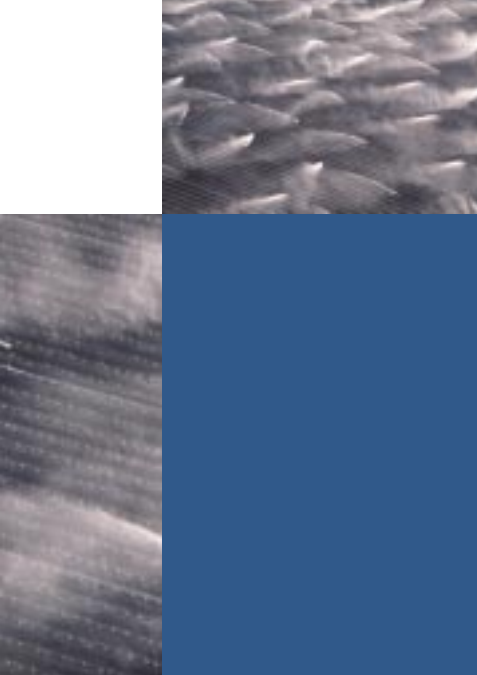
The greatest impact of fraud by far is on staff morale and motivation. The reason? Incidences of fraud often lead to the implementation of stricter control procedures, which can create the impression that management has less trust in its employees. Plus, if these controls are also accompanied by punitive measures, morale invariably suffers.

Our research also indicates that the (potential) financial impact from fraud on a construction company appears to be comparatively low compared to the impact of a project going wrong. Since most major construction

projects are adversely affected by delays, disruption and changes leading to increased construction costs, it is likely that that costs related to potential asset misappropriation would be obscured by other cost overruns. The result is that fraud either doesn't show up on a company's radar screen, or is regarded as a peripheral – and therefore easily ignored – blip. Equally interesting was the fact that over a quarter of our survey respondents believed that fraud had no "collateral" impact on their businesses.

The indirect damage from economic crime (construction sector)





Implementing corrective measures

Without the kind of high-level risk management systems that are common in the financial services sector, the construction industry relies to a great extent on relatively informal control tools and organisational codes of ethics as its main fraud prevention tools. While such tools can be developed with relative ease – and, from a management point of view are an effective way of assuring shareholder and stakeholder constituencies that they are “doing the right thing” – informal control tools are often applied inconsistently and ethics codes are rarely consistently adhered to by staff.

Intelligently conceived ethics programmes along with management training in fraud risk issues can contribute – significantly – to creating the kind of company environment that discourages fraud and theft. A company’s ethics code should be clearly articulated and communicated to all of its employees, and everyone, from the board on down, should know how their chosen code of conduct works – what it says, what it permits and what it does not, and also how employees can report their concerns and observations.

Contractors should also be regularly evaluating and refining their project

control tools and ensure such control tools are adhered to throughout the course of construction.

Types of corrective measures taken (construction sector)



Recovering the losses – maybe

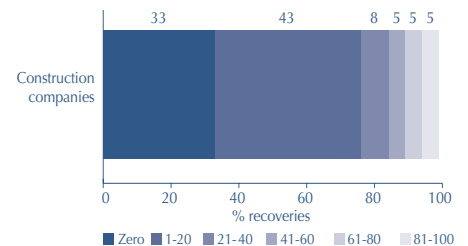
One of the more disturbing statistics that emerged from our research was the fact that, of the construction firms reporting significant levels of economic crime during the last two years, only 15% were able to recover their losses – and then only 40% of the total.

Unfortunately, one third of companies failed to recover anything. Although there may be other factors at work, two of the principal reasons for this are a belief that some levels of fraud are inevitable in business, and the notion that investing time and funds

in an attempt to recover losses is a futile exercise.

The question that arises from all of this is: are there particular reasons that this happens in the construction industry? Explanations abound, but the fact is that on a construction site it is hard to track inventory losses, let alone recover any portion of those losses. What’s more, despite the relatively high levels of fraud found in construction, when it comes to insurance, the industry falls well below the global norm – probably because they would rather face the risk of fraud than pay higher premiums. Is this due to management indifference and/or scepticism over how much could actually be recovered?

Recoveries from economic crime (construction sector)



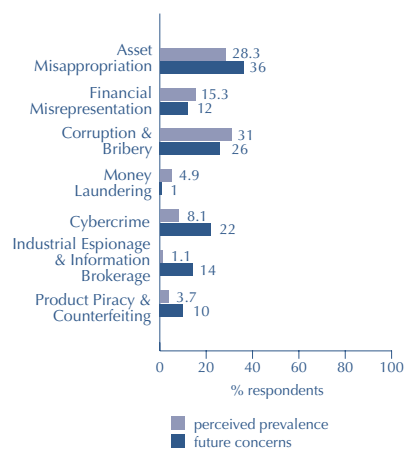
Building a fraud-free future

Over the next five years the construction industry will see a growing use of IT systems, and their utilisation will clearly have a major impact on such areas as inventory control, transportation logistics and financial oversight. Hopefully it will also lessen the opportunities for corruption and bribery. However, the proliferation of sophisticated IT systems may also see a proportionate rise in the incidence of cybercrime

An increase in asset misappropriation was also seen as a possibility, although many felt that incidences of corruption & bribery would probably decline, probably due to the ongoing impact of such legislation as the Foreign Corrupt Practices Act and the UK Corruption Bill. However, one area of grave concern was industrial espionage, which respondents felt would grow considerably in frequency and scope.

In general the construction industry seems to be optimistic about its invulnerability to future threats from fraud, especially since there are now a number of international agreements in place designed to lower levels of corruption. Such legislation – and an ongoing drive towards greater transparency and accountability in the industry – could account for the positive viewpoint.

Future threats from economic crime compared with currently perceived prevalence (construction sector)



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Note

Full details about the methodology and demographics of the survey along with definitions of the terminology can be found in the Global Economic Crime Survey 2003 report, which can be downloaded from the dedicated www.pwc.com/crimesurvey website.

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