

Change Orders: A Gateway to Construction Fraud and Misconduct

Agenda

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Introduction

Fraud and misconduct in construction have become a pervasive problem globally, with up to \$5 trillion expected to be lost to corruption by 2030. One of the areas where these illicit activities often occur is during the change order process, where individuals on the client side collude with contractors to engage in fraudulent practices. The aim of this article is to highlight the gaps in which change orders can be used as a cover for misconduct and fraud, and to underscore the need for proper governance and processes to mitigate these risks.

Understanding the scope of works

In this article, we will focus on the gaps in which change orders can be used as a cover for misconduct and fraud. It's worth noting that some of these gaps may arise from negligence, unqualified personnel, or fast-track delivery, rather than direct or planned fraud schemes.

To understand these gaps and how fraud can occur, it's essential to first understand the components of the scope of work and how changes can impact it.

The components of SOW are mainly:

1. **Project overview:** This section should provide a brief description of the project, including its location, purpose, and expected outcomes.
2. **Work description:** This section should describe the specific work that will be performed as part of the project. It should include detailed information about the materials, equipment, and labor that will be required, as well as any special requirements or conditions that must be met.
3. **Schedule:** The scope of work should include a detailed schedule for the project, including start and end dates, milestones, and key deliverables.
4. **Budget:** The contract should include a budget for the project, detailing the estimated costs for materials, labor, and other expenses. This section may also include a contingency budget to cover unexpected costs.
5. **Quality standards:** The scope of work should specify the quality standards that must be met as part of the project, including any industry standards or regulations that must be followed.
6. **Change orders:** The contract should include provisions for change orders, which allow for modifications to the scope of work during the project.
7. **Payment terms:** The scope of work should include details about payment terms, including the amount and timing of payments, as well as any penalties for late payment.
8. **Insurance and bonding:** The contract should specify the insurance and bonding requirements for the project, including liability insurance and performance bonds.
9. **Safety and security:** The scope of work should include provisions for safety and security measures, including any required safety equipment or training, as well as security measures to protect the project site and materials.

10. Completion and acceptance: The scope of work should include provisions for project completion and acceptance, including any required inspections or approvals, as well as any warranties or guarantees for the work performed.

Now remember, every single component way of writing in the TOR is the door to change later and it might create an opportunity for misconduct or fraud.

The Fraud Scenarios in Change Orders

Let us discuss a few scenarios to gain a deeper understanding of the issue at hand, which can help us design proper governance and processes. However, despite the implementation of sound governance and processes in some clients systems, they are unable to fully adhere to them due to various reasons. For instance, a contractor may delay the work or refuse to comply with specifications deliberately, possibly to avoid financial losses. In such instances, the client is left with little choices but to accept essential works (not critical) required to start the facility operation. Example, an important road with failed CBR asphalt test. However, the amount that can be deducted from the contract is often insufficient to cover the cost of remedying the work, which leaves the client in a precarious situation and might force them to go to court in some cases.

However, the overall control gap is not having proper budget estimation.

A lack of clear budget definitions in large portfolios can also create opportunities for fraud using change orders. When budget definitions are not clearly established for each portfolio, it can be difficult to determine what costs are associated with individual projects. Additionally, when there is shared infrastructure and facilities among portfolios, there may be overlapping costs that are not clearly defined.

For example, a contractor may intentionally submit a low bid for a project within a large portfolio with shared facilities and infrastructure, knowing that they can use change orders to increase the cost of the project later on. This can result in additional costs being unfairly allocated to other projects within the portfolio.

In addition, a lack of clear budget definitions and shared facilities and infrastructure can create opportunities for collusion between contractors and clients. A client may deliberately create a budget that is not clearly defined or allocate shared infrastructure and facilities costs in a way that benefits a particular contractor. This can allow the contractor to use change orders to inflate the price of the project, knowing that they have the support of the client.

Having said the above, lets move to discuss the potential fraud scenarios using change order as cover might be as followings:

1. Collusion between someone in the client side and the contractor: The client and the contractor collude to manipulate the bidding process, with the contractor submitting a low bid for the initial project knowing that they can use change orders to increase the scope and price later on. Ex. here, the contractor price for unit rate for this particular item, will be priced high and the other items priced low to win the LS contract. So the margin in this item is so high.
2. Intentionally submitting an incomplete or ambiguous bid: The contractor may intentionally submit an incomplete or ambiguous bid, leaving out important details or subcontractors.

This allows them to use change orders to add these details or subcontractors later, increasing the overall cost of the project. Ex, accepting a bid in the first stage of evaluation of the tender, even with missing such important details. Then during second stage and negotiation, this work excluded or priced as Provisional Sums.

3. Using provisional sums in a contract can create opportunities for fraud and misconduct in the construction industry. Provisional sums are amounts allocated in a contract to cover potential future expenses that cannot be determined with certainty at the time of the contract's signing. These expenses could be related to unforeseen conditions or changes in design, among other things. One way that provisional sums can be exploited for fraudulent purposes is when contractors deliberately underestimate the actual costs and allocate a lower amount for provisional sums in the contract. This allows them to submit lower bids and win the contract, even though they know that the actual costs will be significantly higher. Once the project is underway, contractors can then use change orders to inflate the costs and claim additional funds from the client.

In some cases, contractors may also use provisional sums to hide costs that they do not want to disclose upfront. This can be done by allocating an amount to provisional sums that is lower than the actual cost of the work. Once the project is underway, contractors can then use change orders to increase the amount of provisional sums to cover the actual costs, resulting in an inflated contract price. Moreover, contractors can also use provisional sums to conceal other fraudulent activities, such as kickbacks or bribes. By allocating funds to provisional sums, contractors can disguise the true cost of work and use the additional funds to make illegal payments.

4. Omitting important information from the scope of work: The client may omit important information from the scope of work, intentionally or unintentionally, which allows the contractor to manipulate the process to their advantage. In one scenario, where you tender full package including buildings, Power Station, infrastructure to a contractor specialised in buildings only who will associate with others. After winning the work, the client omit the power station (for example), because the contractor failure to deliver proper documentation and approved subcontractors for the power station.
5. Non-clear procurement strategies: When the procurement process is not clearly defined, it can create opportunities for fraud. For example, a client may deliberately create a non-clear procurement strategy in order to benefit a particular contractor. The contractor can then use change orders to inflate the price of the project, knowing that they have the support of the client. Example, there are a need for a wastewater plant. Any big development will require power, water, wastewater during construction and after development completion. When you don't start the procurement strategy with this essential infrastructure means, to add such cost to all portfolios and projects which ass huge cost to all contracts. In case a client is colluding with the contractor, when contract size increase, the commission increase.
6. Shared facilities and infrastructure: When multiple projects share facilities and infrastructure, it can be difficult to allocate costs fairly. A contractor may intentionally submit a low bid for a project within a large portfolio with shared facilities and infrastructure, knowing that they can use change orders to increase the cost of the project later. This can result in additional costs being unfairly allocated to other projects within the portfolio.

Similarly, the contractor might price the shared facilities and infrastructure in the contract while, he is receiving it free or with special discount from the client.

7. **Inflating costs:** A contractor may intentionally inflate the costs associated with change orders. For example, they may charge a higher hourly rate than is reasonable or may claim that materials cost more than they actually do. Here, when they request the change order, they request it from the contractor only without seeking other prices from contractors on site or in near sites. Also, requesting this item from this contractor knowing there is another contractor on site with less price or high quality on the same site.
8. **Concealing or misrepresenting the true cost of change orders:** Contractors may conceal or misrepresent the true cost of change orders by hiding costs within other line items or billing for unnecessary or fictitious items. This can result in clients overpaying for work that was not actually performed or for materials that were not actually used. Example, approving a change order with no full details attached like design, BOQ, specification, schedule, ..etc) which force the client for another change order as a result of it.
9. **Inflating the scope of work:** Contractors may inflate the scope of work in order to generate additional revenue. For example, they may claim that additional work is required when it is not, or they may intentionally create change orders for work that was already included in the original scope. Here, the experience of the ones who are doing the change order approvals crucial. Contractors are most of the time more experience than the client.
10. **Failing to properly document change orders:** Failure to properly document change orders can create opportunities for fraud. Contractors may claim that change orders were approved when they were not or may forge signatures on change order documents in order to inflate the cost of the project. This is rare, however, for no expert accountants, they will have a change order signed and approved for payment. The process of payment should include the full report of executed work.
11. **Kickbacks:** Contractors may offer kickbacks or other forms of bribes to individuals involved in the procurement process or construction supervision in order to secure a contract or to inflate the cost of change orders.
12. **Inaccurate estimates:** Contractors may intentionally provide inaccurate estimates for change orders in order to win a contract. This can result in clients overpaying for change orders or for the entire project.

The above, by the way, are only some scenarios from many it might occur. Some of the above might shock you. However, the real life is more shocking when we all know that the budget overrun is a pandemic and cost the economy more than what we can measure in case it effect people lives which does in many cases.

Conclusion

Change orders, although necessary in construction, it can become a fertile ground for fraud and misconduct in the industry. To mitigate these risks, clients must put in place proper governance, processes, and control teams to ensure that change orders are used only for legitimate reasons and are transparently documented. By doing so, we can help to combat fraud and misconduct in construction and ensure that projects are completed on time, within budget, and to the highest standards of quality.

For consultancy services to study your system gaps or for your team training on the above GAPs and what controls to add, please contact us info@zalbasireppm.com

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