

## Forms of Change Order Fraud and How to Spot Them

By Aaron Cook, Director, [Marcum LLP](#)

History indicates that economic turmoil increases the prominence of fraud across industries. Today, macroeconomic trends in construction—including rising labor and material costs—may suggest a higher fraud rate will affect construction interests in the short term.

Even absent the issues squeezing construction margins, fraud has risen over the past six years. According to the Association of Certified Fraud Examiners, there were approximately 56 cases of fraud per year, on average, between 2016 and 2022. That represents an increase of roughly 60% compared to the average of 35 fraud cases per year between 2008 and 2014. One recent and notable example can be seen in the Department of Justice's early 2023 indictment of 24 individuals and 26 companies in a massive construction industry corruption scheme centering on kickbacks, conspiracy, and change order fraud carried out in New York. With fraud becoming more prevalent, it's important that those in the industry learn to recognize the tell-tale signs of common forms of fraud.



### Legitimate Uses

Change orders are a common and often justifiable method of repricing contracts to reflect changes in circumstances, unforeseen expenses, and other necessary amendments to previously agreed construction rates. A change order can be initiated by either contracting party, according to the terms of the contract. A project owner that sees the need for a change in scope or specification will formally adapt the project requirements by submitting a change order.

For example, to stay within budget, a project owner may decide to save on rising construction costs by reducing the original size of, or amenities within, a property development. Alternatively, new technologies or innovations might spur the project owner of a healthcare facility to modify the project to accommodate new medical equipment or devices.

There are other less common reasons to modify a contract, including:

- Construction completion dates
- Contract types
- Construction management fees
- Labor, equipment, and overhead rates
- Compensation for owner delays

### Anatomy of Change Order Fraud

Of course, the ubiquity of change orders has allowed them to become a favored tool for abuse, by which bad actors can take advantage of various factors (like an ongoing project's deadline pressure) to drive up the price of construction that's already underway. Furthermore, proving that a change order is unlawful may be challenging for those unprepared to conduct a thorough investigation of the circumstances or without control procedures capable of catching fraud in progress.

Change orders often receive less scrutiny for approval than the original bidding and award process, which creates an inherent opportunity for abuse. For instance, the initial bidding process often requires the approval of numerous project officials, whereas change orders often only require the authorization of one individual. So, where a fraudulent bidding process might require collusion among multiple project officials, change order fraud may only involve a kickback from the contractor to the singular project official authorized to execute contract modifications. In a recent change order fraud case, a Connecticut man was convicted for inflating change orders to a subcontractor in exchange for kickbacks such as gift cards.

Change order fraud can occur even in a "hard-bid" environment, where all bids are sealed and the lowest bidder wins. For instance, a contractor, in collusion with project officials, can submit a very low bid to secure a contract. Subsequently, a change order can be executed that significantly increases the contract's price. The additional contract value can then compensate the contractor and fund bribes to project officials.

A similar scheme can be seen in unit-price contracts whereby the contractor is instructed to "low-ball" work quantities that will be reduced or

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eliminated from the scope via a change order while more lucrative work quantities are increased. By bidding low (even below cost) on these line items, the contractor can be assured of having the lowest price and winning the contract.

Similarly, a contractor might be tipped off that high-priced line items will be increased throughout the project. For example, a highway project might call for several hundred safety barrels when the project will require several thousand. A contractor in the know could price these items high and other line items low, thus, securing the lowest bid and ultimately use additional profit from the many additional safety barrels to pad their pockets and fund the kickbacks to the project official(s).

Another example of fraud carried out via change orders is called unbalanced bidding. In these cases, a consultant may guarantee that a target company will win the bid in question by following their guidance during the bidding process. In return for the guarantee of being awarded the work, the company will pay the consultant a high fee to be shared with the project officials. The consultant will inform the bidder that certain line items will be the subject of change orders, dropping them from project requirements. The competitors bidding for the work will be unable to compete on price, as the bidding company working with the corrupt consultant will be able to vastly underprice these items knowing they will not be necessary to complete the work.

Not every form of change order fraud requires broad or sophisticated collusion. Sometimes all it takes is an unscrupulous contractor and an unsophisticated project owner. For instance, a contractor might seek additional compensation through a change order for work already covered in the existing contract price.

A construction contract can specify the profit and overhead rates to be incorporated into any contract change orders. However, a project owner can easily overlook these terms, allowing a contractor to bill higher rates on work subject to a change order. Other times, change order work is to be billed on a time and material basis with no maximum price. This creates an opportunity for a contractor to invoice a project for services not rendered and/or materials never delivered or otherwise diverted.

### Spotting Red Flags

Change order fraud is not new or novel, making it relatively easy to assess suspicious activities and identify bad actors.

The International Anti-Corruption Resource Center released a 2023 version of its Guide to Combatting Corruption and Fraud in Development Projects, with a number of questions that can be asked to help determine if change order fraud might be occurring. A select few of these questions include:

- Are the procedures in place for the request and approval of change orders being followed?
- If not, what exceptions have been made and why?
- Do certain contracts receive a high number of change orders? If so, who approves them?
- Are the change orders that receive approval adequately justified and documented?
- Have you identified patterns of low bid awards to certain contractors that are followed by change orders?
- Are high- or low-priced line bids followed by change orders extending the quantities of high-priced items or reducing or eliminating low-priced items?

Finally, whether or not active fraud is suspected, certain conditions or practices justify an investigation. These include:

- Poorly documented or hard-to-justify change order requests and approvals.
- Patterns of low-bid contracts followed by change orders increasing the price of the contract.
- Patterns of sole-source contract awards just below the competitive bidding threshold, followed by change orders that increase the price above that threshold.
- A single or small group of contractors that receive a disproportionately high number of change orders compared to other contractors, or similar contracts.
- The involvement in a project of certain individuals or entities with a reputation for corrupt practices.
- Controls or procedures that are known to be lacking, including having a single individual certify the need for and approve a change order.

### Conclusion

Change orders are a necessary aspect of complex projects and a known vector for risk. Equipped with an understanding of how they can be used to further fraud, developers and contractors are better able to prevent change order related abuse.



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