



WHITE PAPER

# Preventing Fraud by Construction Contractors

**Jeffrey N. Aucoin, CPA, CFF, CFE, CIA**

**Joel K. Bobo, CPA**

**Ann R. Cleland, CPA, CIA**

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## Preventing Fraud by Construction Contractors

Many governmental entities have begun significant construction projects in the last two years. The delayed maintenance of infrastructure, along with the opportunities provided by the American Recovery and Reinvestment Act of 2009 (“ARRA”), have allowed governments to begin numerous projects that otherwise may not have started for years.

The volume of the projects and the transparency requirements of ARRA have created unprecedented oversight demands. No governmental entity wants to be on the front page of the local paper as having been the victim of fraud by an unscrupulous contractor as related to negotiated, cost plus, or incremental pricing contracts. The good news is that scrutiny in several key areas can help reduce the risk of fraud by construction contractors. The areas include bidding, direct costs, indirect labor and equipment burden, and overhead.

**Bidding and Project Oversight:** Issues with contracts can start at the very beginning of the process. It is important to ensure the contractor is financially strong, bonded and has no potential conflicts of interest. A government should review the contractor’s financial statements on an annual basis. Further, the contractor’s ownership and management group should be reviewed at the commencement of a project to ensure there are no conflicts of interest. A governmental entity may also wish to review the ownership of all significant subcontractors to evaluate any related parties between the general and subcontractors.

When negotiating contracts, governments should consider establishing fixed fees, or incremental pricing (e.g., per mile) as a way to minimize exposure. Additionally, focus should be placed on establishing a robust change order process at the commencement of the project. Many entities have strong bidding and oversight processes, but realize at the end of the project that costs were significantly higher than expected due to poor management of change orders.

Throughout the bidding and construction process, a government should establish hotlines for vendors and employees to report waste and fraud. These hotlines are a cost effective tool for timely identification of issues and should be widely communicated to everyone involved in the project.

At the commencement of the project, as well as annually, contractors should be required to make an annual ethics confirmation to the government.

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This confirmation should include a statement that the contractor and his or her subs are following the government's Cost of Conduct and Conflicts of Interest policies. Any potential violations can also be disclosed by the contractor for the review of the government.

**Direct Costs:** The cost of materials to be used in a construction project can fluctuate wildly over the term of a contract. In order to minimize the risk associated with variations of raw materials cost, entities should not agree to escalation clauses in contracts. Escalation clauses allow a contractor to charge more for materials if certain events occur. The change in cost is outside the control of the government. A better practice is to agree to a "materials stored" approach in which direct materials are ordered at the commencement of the contract. This approach allows a government to better manage and plan for materials costs as those costs are known from the very start of the project.

**Indirect Labor and Equipment Burden:** Contractors are allowed to add an indirect rate to the direct costs of the contract. These burden rates allow contractors to be reimbursed for the indirect costs associated with a contract. Burden rates can vary widely and should be closely scrutinized when reviewing bids.

Governments should require contractors to provide independent verification of labor rates. Such verification could include a requirement for a contractor to have an AASHTO audit annually, which would provide a written opinion from an accountant regarding the propriety of indirect labor rates. At the very least, contractors should be required to provide audited or reviewed financial statements on an annual basis. These financial statements would show amounts of indirect labor costs such as payroll and unemployment taxes, workers' compensation insurance, general liability insurance, and sick and vacation pay. A government can sum these costs and divide the total by the contractor's direct payroll costs from the financial statements to calculate an approximate labor burden. Significant variances between the calculated and actual labor burden should be investigated.

Additionally, contractors generally charge an equipment burden. In times of economic hardship, a contractor may bill his or her owned equipment as opposed to renting equipment from third parties. The use of owned equipment can be more efficient for the contractor and may result in more favorable lease rates for a governmental entity. Unfortunately, an

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unscrupulous contractor may charge higher rates for equipment owned by his or her company than what would be charged if the equipment had been leased from a third party. In order to mitigate this risk, a governmental entity should review the equipment burden rates to ensure they are reasonable. Many third party databases have standard equipment burden rates by region, such as those maintained by the Construction Financial Management Association. A quick comparison can help an organization identify unusual variances.

**Overhead:** Contracts will permit a contractor to charge through all direct costs incurred plus an overhead and profit percentage. A government will want to closely scrutinize both overhead and profit rates when negotiating contracts. Additional oversight should be in place throughout the term of the contract. A review of a contractor's audited or reviewed financial statements can help an organization determine the propriety of overhead rates on an annual basis. Further, the Construction Financial Management Association provides industry-wide information regarding both overhead and standard profit rates. Regularly reviewing the overhead and profit rates used can allow an entity to detect potential issues early in the process.

Oversight of construction contracts grows more important in today's environment. Scrutiny of the bidding process, as well as direct costs, burden and overhead costs can allow an entity to early detect and address potential issues and to avoid surprises.

**Jeffrey N. Aucoin, CPA, CFF, CFE, CIA**  
**Fraud, Forensic & Litigation Services**  
**Senior Manager**

8550 United Plaza Boulevard, Suite 300

Baton Rouge, LA 70809

Direct: 225.755.9798

E-mail: [jeff.aucoin@horne-llp.com](mailto:jeff.aucoin@horne-llp.com)

**Joel K. Bobo, CPA**  
**Assurance Services Partner &**  
**Industry Director of Construction**

1020 Highland Colony Parkway, Suite 400

Ridgeland, MS 39157

Direct: 601.326.1332

E-mail: [joel.bobo@horne-llp.com](mailto:joel.bobo@horne-llp.com)

**Ann R. Cleland, CPA, CIA**  
**Assurance Services Partner**

1020 Highland Colony Parkway, Suite 400

Ridgeland, MS 39157

Direct: 601.326.1340

E-mail: [ann.cleland@horne-llp.com](mailto:ann.cleland@horne-llp.com)