The Anatomy & Illusiveness of Procurement Fraud

By Tom Caulfield[1]

It's Monday morning you are the company's fraud examiner[2], government auditor, or government investigator. Your computer is logged into the network; and it's time to review the "anonymous" complaints from the day before. While reading, one notification catches your eye:

> *"I don't know if anything is wrong, and I don't want to get anyone into trouble. However, Mr. Bob Jones our Program Manager from the Research and Development Sector seems to be way too friendly with the contractor lead performing work in our sector. I heard that they golf together; fish together and I think their families visit with each other during weekends. Again, I am not sure there is a problem, but I just wanted to tell someone."*

This type of notification is becoming more and more common for people in our profession. This allegation can suggest a range of potential fraud schemes[3] that, if true, could indicate possible violations of organizational policies related to impartiality or conflict of interest. This allegation can also indicate more serious violations of criminal law like receipt of bribes, gratuities, or kickbacks. Welcome to the world of procurement fraud.

Procurement Fraud, or contract fraud as it is sometimes called, is believed by many professionals to be one of the most common and costly of all white-collar crimes. It has become increasingly elaborate -- many times being technology driven -- and it_saddles the public and the private sectors with costs to reputations and balance sheets. Most distressingly, it undermines confidence in the organizational structure and its management. The U.S. Government alone issues over $500 billion per year in Federal contracts, grants and loans - $500 billion of our tax dollars. This paper will analyze procurement fraud in a manner that will allow the reader to understand procurement fraud's unique characteristics and its detection difficulty. It is intended that through a better understanding of procurement fraud and its illusiveness, you can develop a more effective strategy to prevent and detect these frauds in your organization. Let me warn you – that as I start highlighting procurement fraud's illusiveness it does sound like we are fighting an unconquerable foe – but we are not – procurement fraud detection and investigation is difficult – but once understood it is conquerable.

Fraud at its most basic level is defined as "an intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing or to surrender legal right[4]"; or simply stated - a false representation of the truth, involving trickery and deception in order to illegally enrich the fraudster. With *procurement fraud*, the misrepresentation of the truth, in most

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[2] Fraud Examiners are those persons responsible for exposing and resolving fraudulent acts within their organization from inception to disposition. More specifically, fraud examination involves obtaining evidence and taking statements, writing reports, testifying to findings, and assisting in the detection and prevention of fraud.

[3] Fraud scheme is the specific methodology used to commit, conceal and benefit from the fraudulent act.

[4] Black's Law Dictionary, 6th ed., by Henry Campbell Black, West Publishing Co. 1979

cases, occurs somewhere in the acquisition process[5]. It is a misrepresentation fashioned by a fraudster(s) who has a deep operational knowledge of your process and therefore connected to the contract. This connection can stem from a person providing services or products under the contract, a person marketing the contract, a person overseeing the performance/delivery of the contractor, or the person negotiating the contract price on behalf of the victimized organization. Procurement fraud often starts out "under the radar screen" with a systematic abuse of trust sometimes combined with an overly broad delegation of authority. When procurement fraud is discovered, the tendency may be to characterize it as an isolated instance when a more thorough examination would uncover a pattern.

Depending on the fraud scheme being employed, the consequences of procurement fraud will always involve some type of loss and in most cases a financial loss. However, some fraud schemes can also jeopardize personal safety, like in schemes involving defective products, counterfeit parts, and product substitution. Unlike financial and accounting fraud, procurement fraud is slightly less likely to be driven by senior management; it is more likely to be found in organizations with weaker controls, culture and/or morale. We have also found procurement fraud more often in companies that are more geographically remote; where divisions, operations and processes are not central to a company's main business; and in places where the "tone at the top" is not effectively communicated. Procurement fraud prevention is a significant challenge for multi-national companies since many times they operate in regions and industries around the world where the local business environment and culture are permissive or where fraudulent behavior may be encouraged or even required.

For many years white collar crimes were considered to be a "victimless crime" and therefore tolerated as the government or the company was viewed as having plenty of money and losses were either considered insignificant or just part of doing business. This tolerance of procurement fraud has always puzzled me as the Federal False Claims Act can be tracked as far back as the Civil War – so fraud is not new to the American people. That being said, if you look back in history, you can argue that the level of scandals we see today is far greater in frequency than it was in the past and that this increased frequency has caused an American tolerance. Let's compare – during the first half of this century one of the biggest scandals was the 1922 "Tea-pot Dome Scandal" that involved the Secretary of the Interior, Albert Fall. Fall, who took control of several of the nation's public oil reserves, including the Tea-pot Dome oil field in Wyoming, leased them out to interested oil companies. As head of the Interior Department, Fall was allowed to grant such leases. However, as a member of President Harding's cabinet, he was not allowed to accept cash and favors in return for these leases, which he did nonetheless, and generated tremendous wealth in the process.

The *Wall Street Journal* reported that Fall assigned these oil company leases without competitive bidding in acceptance of payment from the lessor. His actions ultimately led to a Senate investigation of what became the "Tea-pot Dome Scandal." By the time it was over, Fall was sentenced to a year in prison after being found guilty of bribery. The case was so unconscionable that it had occupied the country's attention for an entire seven years. Now play

[5] The acquisition process is all inclusive from identification of the requirements; to requesting bids; to receipt of services/material; to making final payment for the contracted item.

that against the last ten years, where we had scandals involving Tom Delay, Mark Foley, Duke Cunningham, and Bob Ney and total media coverage limited to just a few months. Add that to the fact that according to the General Services Administration (GSA) *Excluded Parties List System* (EPLS), in 2006, there were over 5700 entities (corporations, individuals, etc.) debarred from doing business with the federal government. The GSA was not tracking debarments during the first half of this century, but I will bet you it was less then 5700 entities.

With the ever shrinking dollar and the direct impact of some recent major fraud schemes affecting taxpayers, the somewhat passive acceptance of procurement fraud by the American public has dwindled away. Also influencing this changing perception is the greater financial, legal and reputational impact of procurement fraud today. Influencing that change in tolerance or as a result of that change, there have been changes to the regulatory environment; greater focus by the Department of Justice through the development of the National Procurement Fraud Task Force[6]; and greater attention on voluntary disclosure programs, along with the adoption of more effective conflict of interest programs. Tolerance of procurement fraud by the American tax payer; or casual dismissal of its presence by shareholders is now something of the past.

Determining the true cost of procurement fraud to an organization is a difficult task, as in all frauds, it is masked in deception. Within the 2004 and 2006 Report to the Nation on Occupational Fraud and Abuse, by the Association of Certified Fraud Examiners (ACFE), experts in the field of fraud prevention and detection estimated that occupational fraud[7] cost U.S. organizations between four and six percent of their revenues each year. Studies by the ACFE have also identified that over 66 percent of occupational fraud schemes had run for more than a year before they were detected, and just over 13 percent of them ran for five years or longer before they were detected. With losses of this worth and frauds not being detected for years at a time, it is not surprising that more and more oversight professionals like you are focusing much of their time on fraud prevention and detection.

Detecting Procurement Fraud

The search for procurement fraud can be illusive at times, as on the surface, it generally only leaves faint clues or indicators[8] to be discovered, normally by untrained observers. With today's technology, it is easy to fabricate legitimately-looking source documentation (bidding documents, change orders, invoices, shipping documents); also in today's business environment, we frequently use electronic authorization and electronic signatures. On any given day, valid fraud indicators are being dismissed as administrative oversights when found in documentation, or assumed false indicators when either observed, or overheard. Many program managers and division level management view any hint of fraud in their programs as either negatively impacting their careers or the future funding for their section. These program managers therefore continuously minimize any suggestion that fraud might exist. I am not suggesting these managers are deliberately covering up fraud; they are simply rationalizing away what they

[6] Additional details of the National Procurement Fraud Taskforce are located at http://justice.gov/criminal/npftf/.

[7] Occupational Fraud is a broad categorization of employee misconducts, which would include many procurement fraud schemes only omitting those schemes not involving employee's of the victimized organization.

[8] A fraud indicator is a set of circumstances that are unusual in nature or vary from the normal procurement process.

are observing. "The only thing necessary for the triumph of evil is for good men to do nothing[9]." Or in our case "The only thing necessary for the triumph of procurement fraud is for good people to do nothing."

The best employees to identify procurement fraud indicators, excluding auditors, investigators or fraud examiners, are those people working closest to where the indicators can be found. These occupations are related to: procurement/contracting/purchasing, program management, payroll, accounting, and/or those working under the contract. However, often these occupations have little if any training in identifying fraud indicators, along with what to do once they believe they have found one[10].

Adding to procurement fraud's illusiveness in a significant way is the "veil of trust" the fraudster will carry with some employees of the organization being victimized. Remember the fraudster is usually connected to the acquisition process in someway; therefore the fraudster is currently, or has in the past, interacted at some level with the employees of the victimized organization. The degree of interaction between the fraudster and the employee reinforces this veil of trust, and therefore the fraudster is often considered to be a "trusted agent" by the same people whose trust has been violated. This "trusted agent" status highlights the peculiar dichotomy of procurement fraud; these crimes cannot succeed without trust, but neither can business.

Unlike crimes against persons and property, where the crime committed is apparent (i.e. assault, murder, vandalism, etc.), procurement fraud schemes are much more subtle. Further, during most crimes against a person or property, the criminal act is clearly understood from the beginning and the major investigative question is to identify the person who committed the crime. However, in procurement fraud, many times when the investigation is initiated, the person/subject is in fact known to the investigator, and the investigative question is whether the actions are a violation of a law. Also, in procurement fraud investigations, the fraud indicators that caused the initiation of the investigation are, in reality, simply a lead to a totally different fraud scheme. For example – an observation of split purchases could be an indicator of a procurement official circumventing higher level review within the procurement process in order to expedite a contract action. However, in reality, the split purchase was an attempt by a procurement official to mask his/her decision to not compete a contract award after acceptance of a bribe. Many organizations have a requirement to have an open competition for all contracts over a certain dollar value – by splitting the order a fraudster can stay below that requirement. When investigating procurement fraud indicators, you need to recognize that fraud indicators are overlapping with many different fraud schemes. Therefore, fraud examinations must be flexible enough to accommodate uncertainty regarding the true nature of the fraud scheme – false statements in the bid, false claims through double billing, bribery, kickbacks, and conflict of interest. Each of these procurement fraud schemes could have similar procurement fraud indicators, but not until well into the examination is it possible to realize the full scope of the scheme.

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[9] Edmund Burke, British political writer and statesman in the late 1700s

[10] Contained in the ACFE "The White Paper," Vol. 18, No. 2, March/April 2004, is an excellent article "Recruiting an Anti-Fraud Foot-Soldier Army," by Kenneth R. Dieffenbach, CFE, for the development of a fraud awareness-training program for non-oversight professionals.

At first glance, the procurement process can be overwhelming and somewhat_intimidating, but if you step back and examine the traditional procurement process, it can be separated into four basic parts: 1) the requirements/justification; 2) the selection; 3) the delivery; and 4) the cost/payment. Each of these four parts is vulnerable to their own fraud schemes with some being exploited with multiple schemes. Normally, the procurement process begins with the identification of a requirement. This requirement should consist of a brief description of the type and amount of goods or services that will meet the requirement along with a justification for the requirement. The justification is critical – review them anytime you have an allegation of fraud – missing justifications or weak justifications are the best fraud indicator of an insider conspiracy. Once a requirement is generated and justified, the procurement process is designed to select the best contractor. After the contractor is selected, the requirement is fulfilled through the delivery of some type of services or products and the contractor invoices for payment. That is the good news: the procurement process only has four steps, now the bad - in order to commit procurement fraud, the fraudster need only corrupt one of these four parts.

It gets worse, each one of these four parts can be corrupted in one of a thousand different ways, within basically twenty-four generally recognized fraud schemes, and is only limited to the imagination of the fraudster, and the type of access the fraudster has to the procurement process. Now if that is not enough, also adding to its detection difficulty is the fact that either the contractor alone or the organizational procurement official alone can perform some of these schemes, or they can conspire together and commit the fraud. Clearly, the most difficult of the procurement fraud schemes to detect are those that involve the collusion of the contractor and the organizational procurement official. Collusion between the contractor and procurement official can easily render ineffective any internal controls that might otherwise flag a fraud scheme.

Fraudster Profiles

Along with the four aspects of the procurement process that can be corrupted, there appears to be three types of fraudsters, the *situational opportunist*, the *deviant opportunist* and *the business opportunist*. The situational opportunist is the fraudster that seems to be frustrated at work; who has rationalized his/her right to an illegal enrichment; and simply perpetrates the fraud scheme when the right occasion occurs; normally because of a weak internal control. This is the employee who when caught, witnesses in the company will never be surprised that the person was involved in the fraud.

The deviant opportunist is more proactive; possibly perceived as one of the company's hardest workers; but this person is always on the alert for opportunities to corrupt the system. This fraudster will have a strong group of company advocates who will deny any assertion that the fraudster was involved with any wrongdoing. This type fraudster is also the employee that takes only a few days of leave each year; is the employee who seems to have their "hand" in every process related to their business sector.

The business opportunist is the fraudster who commits an act of fraud that on its face seems to only benefit the company. However, in reality is done by the fraudster to increase his/her standing in the company as someone who can increase business and therefore generate revenues. This type of fraudster is looking for their financial gains in yearly bonuses; awards or incentive pay. This fraudster will shift cost between contracts to make his/her sector appear better managed then it really is; or will cause quality control steps to be removed to ensure more timely deliverables. This fraudster places a greater degree of difficulty for prosecution as the investigator/examiner has to demonstrate with sufficient evidence that the fraudster's actions, let's say in January, were done knowingly to receive monetary compensation at a later time like in December.

If you compare just the *situational opportunist* and the *deviant opportunist*, of the two, the *situational opportunist* is far more prevalent in any contract, but losses are far less. However, if the *deviant opportunist* can bribe an organizational procurement official to allow fraudulent billing submissions with a promise of kickbacks, or a contractor implements a fraudulent cost accounting scheme, the losses can be in the millions. Regarding the *business opportunist*, one might argue their fraudulent acts enhance the company's profit margin. However, in reality these fraudsters are costing companies millions of dollars in civil liabilities as once the fraudulent act is identified the company many times becomes the focus of an external investigation for not having sufficient oversight to prevent the fraudulent act. In a criminal case you have to show malicious intent, but in a civil case the burden is "malfeasance."

When I first started working procurement fraud investigations for the federal government, I rarely had a case involving a fraudulent cost accounting scheme, most likely that was because we as investigators did not understand the impact that those type schemes had on G&A (general and administrative) cost to government contracts. Today, fraudulent cost accounting schemes are a normal case initiation, normal as a bribery or kickback case.

Exposing Procurement Fraud

Next to preventing fraud, an investigator's primary goal is to reveal ongoing violations as quickly as possible in order to minimize their impact. A fraud indicator is nothing more than a set of circumstances that are unusual in nature and vary from the normal procurement process. The discovery of one fraud indicator is not sufficient evidence for a proclamation that a fraud scheme is occurring, it must be "tested-out." To do this, investigators use their professional judgment to hypothesize the how, the where, and possibly who, the fraud scheme is corrupting in the procurement process. Armed with a procurement fraud scheme theory, additional examination is necessary to "test-out" the theory by looking for additional fraud indicators within the procurement process. An understanding of how the more traditional procurement fraud schemes operate is critical in order to do this, along with an understanding of the organization's acquisition process. When and if the additional testing supports the theory, the focus of the examination shifts from examining processes into developing specific steps to now identify the fraudster(s) if they are not already known, along with identifying the total damage to the organization.

When it comes to exposing procurement fraud indicators [the first step to procurement fraud detection], there are two traditional approaches. *Analytical Data Analysis,* which is record dependent, includes: targeted data-mining; computer software monitoring of the procurement process; organizational fraud risk-analysis; forensic accounting; and contract management quality control reviews. The other approach is *Direct Observation,* which is testimony dependent, and includes: procurement fraud detections questions; floor-checks; organizational fraud surveys; and outreach/source development. Of the two, direct observation techniques are much easier. Adding one or two fraud detection questions to an audit, an inspection, or an investigative interview requires minimal effort, floor checks and outreach/source development is common to the auditor, investigator or fraud examiner. On the other hand, analytical data analysis, which is designed/tailored to expose procurement fraud indicators, requires a much more calculated and methodical approach. And while it is a more difficult approach, its results can turn out to be much more successful.

The development of techniques to expose fraud indicators may be the difference between whether fraudsters avoid detection of their illegal activities or they are brought to justice. In most cases, successful techniques are directly and primarily dependent upon the knowledge, skills, and abilities of the professionals performing the work. Consequently, the demand for formal education in fraud and procurement fraud detection/investigation has grown; unfortunately at the federal level it seems limited in its availability.

Regardless of which fraud indicator exposure technique is attempted, there are two important factors that will influence success. First, the approach needs to be *focused* on the most vulnerable procurement fraud threats to the organization, and second, *tailored* to exposing procurement fraud indicators of those same threats. Many organizations seem to forget these important factors and later find themselves wondering why their discovery of procurement fraud indicators is lacking. There are too many possibilities of how an organization could be victimized – it's vital to focus the approach to the most fruitful area – the most vulnerable. To work efficiently – tailor the approach to those same vulnerabilities.

There is no greater tool in the detection of procurement fraud than knowledgeable employees, which includes auditors, inspectors, investigators and fraud examiners, looking for, developing, and reporting, potential procurement fraud indicators. Most contracts are not tainted by fraud and most fraud indicators do not denote fraud. However, by exposing fraud indicators in the most efficient way, and properly assessing them, as oversight professionals we are taking the appropriate steps to uncovering fraudulent acts, identifying the fraudster, protecting our organizational resources, and fulfilling our professional requirements. In closing, remember the only difference between a mistake and a fraud is the intent.

Table 1

PROCUREMENT FRAUD SCHEMES

Contract fraud traditionally includes 24 common and recurring fraud schemes related to the procurement of goods and services by companies and government organizations. These more common schemes include those committed by suppliers alone, by government officials alone and the most dangerous and damaging of all, those schemes in which both sides of the procurement process collude and conspire to defraud. In order to commit procurement fraud; the fraudster need only corrupt one of four aspects of the procurement; the *Requirement,* the *Selection,* the *Cost, or* the *Services Being Delivered.*

It is important to understand that each of these traditional 24 schemes can be conducted a thousand different ways only being left to the imagination of the fraudster and their access to the procurement process.

The following is a list of the more traditional 24 procurement fraud schemes with a brief description of the scheme:

1. <u>Bribe</u> – normally refers to a procurement official receiving a "thing of value" to influence a pending decision.

2. <u>Gratuity</u> – normally refers to a procurement official receiving a "thing of value" as a form of appreciation for a decision.

3. <u>Kickbacks</u> – refers to some type of "thing of value" going back to the procurement official. Traditionally, when a bribe or gratuity is paid it normally will also include the ability to overcharge, or deliverance of non-conforming products or to gain other advantages.

4. <u>Split Purchases</u> – is when a procurement official splits a single purchase into two or more purchases for the sole purpose of each purchase being below upper level review or competitive bidding thresholds.

5. <u>Leaking of Acquisition Data</u> – is when an insider leaks bid/proposal information from other competitors, or leaks confidential pre-bid procurement information to a favored bidder to give them an unfair advantage in the bidding process.

6. <u>Change Order Abuse</u> – a procurement official knowingly allows a contractor to submit a "low" bid without any margin of profit, because of an agreement to post-award change orders.

7. <u>Bid Manipulation</u> – an insider can manipulate the bidding process in a number of ways to benefit a favored contractor or supplier. These include accepting late bids, changing bids, re-bidding work and so on.

8. <u>Rigged Specifications</u> – an insider unduly narrows specifications allowing only a favored contractor to qualify, or unduly broadens specs to qualify an otherwise unqualified bidder.

9. <u>Unjustified Sole Source</u> – an insider deliberately writes a non-supportable sole source justification to avoid a competitive selection.

10. Unnecessary Purchases – an insider deliberately purchases equipment or services not required, but done so to allow a contractor to profit by the purchases.

11. Purchases for Personal/Resale – an insider purchases items that are intended for his/her own use, or for resale.

12. Conflict of Interest – the government official makes a decision that affects him/her financially or a former procurement official now working for a contractor and making representation back to the government on a contract they were involved with as a government employee.

13. Phantom Vendor – an insider submitting invoices from a non-existent vendor.

14. Market Sharing – contractors divide markets or product lines and agree to not compete against each other.

15. Complementary Bidding – several contractors secretly agree to submit complementary high bids to allow their own pre-selected contractor to win contracts on a rotating basis, or to divide contracts by territory (see market sharing), or take other steps to defeat the competitive process and divide work. This is sometime referred to as "bid-rotation."

16. Bid Suppression – is one contractor paying-off other competitors to not bid, or use more forceful means to discourage participation by competitors.

17. Defective Pricing - refer to government contractors who fail to disclose accurate, current and complete pricing data in a contract proposal on cost type contracts.

18. Fraudulent Cost Accounting - costs that have not occurred, not reasonable, or which cannot be directly or indirectly allocated to the contract.

19. False Claims – no services or goods were provided.

20. Inflated Claims – higher cost than actually incurred.

21. Multiple Claims – single incurred cost submitted on different contracts or multiple times to the same contract.

22. Defective Quality – contractor substitutes products with material of lesser quality than specified or uses counterfeit; or defective or used parts.

23. Manipulation of Delivery – delaying the contract deliverable to allow cost to be incurred.

24. False Statement/Certification – a contractor that knowingly delivers work, goods or services that do not meet contract specifications may be guilty of fraud if they falsely represent that the deliverable has complied with the contract. If the contractor has not made fraudulent representations or concealed its acts, the contractor may only be liable for breach of contract rather than fraud.

Table 2
This chart helps to link the scheme to whom or if a conspiracy is required for the scheme. The chart also identifies what part of the procurement process is most likely corrupted during the scheme. It is important to remember that most schemes that corrupt the selection process also corrupt the cost later, as a fraudster does not pay a bribe, gratuity or a kickback out of profit. As for schemes that are marked with no conspiracy required if the scheme is occurring with the knowledge of the procurement official then you will also have kickbacks.

Scheme	PO & C[11]	C & C[12]	None	Corrupt Aspect
Bribe	X			Selection
Gratuity	X			Selection
Kickback	X			Selection
Split Purchases	X			Selection
Leaking of Acquisition Data	X			Selection
Change Order Abuse	X			Selection
Bid Manipulation	X			Selection
Rigged Specifications	X			Requirements
Unjustified Sole Source	X			Selection
Unnecessary Purchases	X			Requirements
Purchases for Personal/Resale			X	Requirements
Conflict of Interest			X	Selection
Phantom Vendor			X	Selection
Market Sharing		X		Selection
Complementary Bidding		X		Selection
Bid Suppression		X		Selection
Defective Pricing (TINA)			X	Cost
Cost Accounting			X	Cost
False Claims			X	Cost
Inflated Claims			X	Cost
Multiple Claims			X	Cost
Defective Quality			X	Service/Delivery
Manipulation of Delivery Times			X	Service/Delivery
False Statement/Certification			X	All

[11] PO & C is conspiracy between Procurement Official/insider and Contractor
[12] C & C is conspiracy between Contractor and Contractor