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Detection and Prevention of Contract and Procurement, Fraud Crtalyst to Organization Profitability

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Abstract: *Procurement in any organization setting cannot be understimated. This is because it involves the acquisition of materials, goods and services required for the organization's operation of her to attain its set profitability. In the process of carrying out these responsibilities in many organizations, diverse number of frauds have been detected and efforts would be made in this paper to find appropriate ways of curbing these procurement frauds so that the set organizational profitability goals will be achieved. Apart from leading to organization profitability, it can equally lead to organizational growth and saving organization investments.*
Key Words: *Procurement, Fraud, Detection, Prevention, Profitability.*

I. Introduction

Procurement fraud can be defined as illegal conduct by which the offender gains an advantage, avoids an obligation or cause damage to his organization. Author the offender might be an employee, owner statutory board member, an official, a public figure or a vendor who is involved in the purchases of services, goods or assets for the affected organization.

Procurement fraud schemes are very common and this includes corruption, billing schemes and conflict of interest

According to Donald & David (1996), corruption means bribes in form of gifts or other advantages of various types. Corruption can occur at all stages of goods and services purchased, i.e in the bidding phase, during the supplier selection, and in the acutal goods delivery stage. The best- known forms of corruption include:

- Purchase terms tailored for a selected vendor
- Circumvention of the bidding process (bid rotation, bid suppression, creation of complementary and phantom bids, and/or disqulification of qualified applicants)
- Low quality goods delivered instead of the originally contracted ones, incomplete contracts or improper biliding.

In billing schemes, the company purchases and pays for goods and services which do not exist, overpriceding or which the company does not need at all

Fraud schemes involving conflict of interest include transferring the employer's customer base to one's own company, purchase of overpriced goods/services from companies related to an employee of the affected company or favouring of related companies within the bidding process.

There are specific fraud risks, where investors that are new to the country are exposed to longer supply chains, a different economic climate, unfamiliar trade practices, language and cultural barriers.

Motives of Procurement Fraud

The motives for comitting this type of fraud include gaining funds for personal purpose, taking an opportunity upon finding a weaknesss in the control system, and winning advantages for related parties. Another motive could be blackmail of an employee by a third party, or preferential treatment of a business partner.

Indicators of Procurement Fraud

Procurement fraud indiicators include:

- Unsuccessful introduction of control processes in the purchase department
- Unkonwn vendowns recently established companies
- High employee turnover in the purchasing department
- Favoring of certain vendors for a reason
- Preferential relationship between person(s) from the company with person(s) from the vendor (e.g joint vacation or leisure the activiies).
- Vendor without an apparent competiitive advantage or with low-quality goods and services regularly winning the bidding process
- Frequently occurring reports and suspicions of misconduct by an employee or an entity.
- Frequently missing documentation for importat purchases (contracts, bills of delivery, price lists).

Procurement fraud can be one of the most complex frauds to investigate, there are numerous ways it can be committed and, when investigating it, all options needed to be considered.

A simple definition of procurement fraud would be fraud within the procurement lifecycle of a product or service, not forgetting long-term maintenance contracts.

The Office of the Deputy Prime minster (ODPM) defines procurement as the process of acquiring goods, works and services, covering both the acquisition from third parties and from in-house providers.

The process spans the whole life cycle from identification of needs, through to the end of a service contract or the end of the useful life of an asset. It involves options appraisal and the critical "make or buy" decision'.

Often when concerns are raised, products and services have already been procured and the contracts have been in place for some time.

In some cases, the fraud is often embedded in the contract and can be difficult to spot. It also presents a further difficulty as often contractual supplier relationships have been long established and therefore caution is required when deciding who to approach for information or indeed who to appoint to investigate.

Types of Procurement Fraud

There are many ways that procurement fraud can be committed but the main types are:

- Bid rigging /bid splitting,
- Creation of sheel companies to facilitate fraudulent payment
- Collusion between suppliers
- Purchase order and contract variation orders
- Unjustified single source awards
- False invoices for products and services for suppliers that do not exist.

Fraud is a million-dollar business and it is increasing every year. The PEC global economic crime survey of 2009 suggests that close to 30% of companies worldwide have reported being victims of fraud in the past year.

Fraud involves one or more persons who intentionally act secretly to deprive something of value, for their own benefit. Fraud is as old as humanity itself and can take an unlimted variety of different forms. However, in recent years, the development of new technologies has also provided further ways in which criminals may commit fraud. In addition to that, business re-engineering, re-organization or downsizing may weaken or elimintate control, while new information systems may present additional opportunities to commit fraud.

Detecting Procurement Fraud

Decker (1998) observed that traditional methods of data analysis have long been used to detect fraud. They require complex and time-consuming investigations that deal with different domains of knowledge like financial, economics, business practices and law. Fraud often consists of many instances or incidents involving repeated transgressions using the same method. Fraud instances can be similar in content and appearance but usually are not identical.

The first industries to use data analysis techniques to prevent fraud were the telephony companies, the insurance companies and the banks (Decker, 1998). One early example of successful implementation of data analysis techniques in the banking industry is the Falcon fraud assessment system, which is based on a neural network shell.

Retail industries also suffer from fraud at point of sale (POS). some supermarkets have started to make use of digitized closed-circuit television (CCTV) together with POS data of most susceptible transactions to fraud.

Internet transactions have recently raised big concerns, with some research showing that internet transaction fraud is 12 times higher than in-store fraud.

Fraud that involves cell phones, insurance claims, tax return claims, credit card transactions etc. represent significant problems for governments and businesses, but yet detecting and preventing fraud is not a simple task.

Fraud is an adaptive crime, so it needs special methods of intelligent data analysis to detect and prevent it. These methods exist in the areas of Knowledge Discovery in Databases (KDD), Data Mining, Machine Learning and Statistics. They offer applicable and successful solutions in different areas of fraud crimes.

Techinques used for fraud detection fall into two primary classes: Statistical techniques and artificial intelligence, example of statistical data analysis techniques are:

Data preprocessing techniques for detection, validation, error corrrection and filling up of missing or incorrect data. Calculation of various statistical parameters such as so on. For example, the averabes may include average length of call, average number of calls per month and average delays in bill payment while artificial intelligence include;

- Models and probability distributions of various business activities either in terms of various parameters or probability distributions.
- Computing user profiles
- Time series analysis time-dependent data
- Clustering and classification to find patterns and associations among group of data
- Matching algorithms to detect anomalies in the behavior of transactions or users as compared to previously known models and profiles;

Techniques of fraud detection are also needed to eliminate false alarms, estimate risks, and or edict future of current transactions or users

In accounting profession, some accountants specialize in forensic which is the procurement and analysis of electronic data to reconstruct, detect, or otherwise support a claim of financial fraud. The main steps in forensic analytic are:

(a) Data collection,
(b) Data preparation
(c) Data analysis and
(d) Reporting. For example, forensic analytics may be used to review an employees' purchasing card activity to assess whether any of the purchases were diverted or divertible for personal use. Forensic analytics might be used to review the invoicing activity for a vendor to identify fictitious vendors, and these techniques might also be used by a franchisor to detect fraudulent or erroneous sales reports by the franchisee in franching environment.

Fraud management is a knwoledge-intensive activity. The main all techniques used for fraud management include: Data mining to classify, cluster, and segment the data automatically find associations and rules in the data that may signify interesting patterns, including those related to fraud.

Expert systems to encode expertise for detecting fraud in the form of rules. Pattern recognition to detect approximate classes, clusters, or patterns of suspicious behavior either automatically (unsupervised) or to match given inputs.

Machine learning techniques to automatically identify characteristics of fraud. Neural networks that can learn suspicious patterns from samples and use later to detect them. Other techniques such as link analysis, Bayesian networks, decision theory, land sequence matching are also used for fraud detection.

II. Reasons For Procurement Fraud

Bouwmans (2003) observed that, throughout the supply chain, there are many opportunities for numerous people to commit procurement fraud. From procurement to distribution, both employees and external parties, such as suppliers, distributors and competitors all have opportunities. These range from false invoicing, bribery and kickback schemes to inventory theft and substandard goods. Some of the red flags to look out for include.

- Poor or non-existent record keeping
- Higher price/lower quality goods
- Excessive entertaining of procurement staff by suppliers.
- Deviations in communications between procurement staff and supplier such as calls, or text messaging to mobile phones
- Procurement staff demanding extended periods of notice before they allow an audit to take place and
- Inexperienced buyers.

How to control procurement fraud

Though, organization must keep on working till when the so called procurement fraud will be finally eradicated, a task which seems impossible, but achievable. This can only be done if certain control measures are put in place, the following steps can be used as methods of controlling procurement and contract fraud.

1. Ensure the risk of procurement fraud is acknowledged on your company risk register, and there is a risk owner who has overall responsibility in the organization.
2. Ensure all staff who are able to make or are involved in financial decisions are trained how to identify procurement fraud. Do not dismiss minor red flag indicating possible fraud such as a perceived close relationship with a supplier that may be closer than you think.
3. Ensure a three-way match is carried out. So do the amounts documented on the requisition, purchase order and invoice all attalign? Do not forget the delivery note and also check against the contract schedule.

4. Staff members often move to other departments within an organization. If a staff member moves departments, remove all of their current permissions and authorities and the permission applicable to their new roles.
5. Ensure the procurement process is followed and is enforced. Has a order been placed before the procurement paparwork has been raised? If so why?
6. Segregation of duties is a recognized procurement fraud barrier but is not always enforced. In addition, a two-person system should be implemented to define who can either add or delete a supplier from the approved supplier list or change a supplier’s bank account number.
7. When auditing suppliers (both framework and nonframework suppliers), identify the sub-contractors. Do your contracts stipulate that sub-contractors must be agreed to by your organization before they are engaged?
8. Implement a variation limit for costs on both contracts and on projects. If the costs go over an agreed limit, the reason can be explained and investigated before it is too late.
9. Is your organization proactive in preventing procurement fraud? It is worthwhile carrying out proactive data set matches of your staff against supplier looking for shared bank accounts, address and telephone numbers. There is other information that can be gleaned from this data apart from conflicts of interest such as suppliers sharing office buildings that you did not know about.
10. Analyzing your spoiding patterns with your suppliers this will ensure you are spending what you think you are. Check that your procurement thresholds are being followed and there is no evidence of splitting orders to circumvent tender thresholds.

III. Prevention Of Procurement Fraud

John & Coyle (2003) observed that, all organizations are prone to fraud and corruption in their procurement cycles. The fallout from a reputational perspective as well as a financial assistance of it can be disastrous. With the growing number of companies using suppliers based in Asia, the instances of fraud and corruption in the procurement cycle are increasing. Illicit rebates, kickbacks and dubious vendor relationships are all too common. Whilst a common can implement or have controls in place to reduce the likelihood of these occurencies, the risk can never be fully eliminated. Instance of fraud and corruption in the procurement cycle are not easy to detect, prove or prosecute. They are often dealt with internally and implicated empolyees are allowed to ‘resign’ with their reputations intact. During a normal business cycle a high risk fraud environment is typified by pressurer, rationalization and opportunity. These factors are exacerbated with an economic meltdown. The global financial tsunami appears to be both unveiling more fraud and increasing the pressure on individuals to meet and maintain double digit growth previously experienced. It is this type of mindset in slower economic times that can contribute to increased fraudulent activity. Aside from the cases mentioned above, employees or the officers, put in position where they are requested to pay or are offered a bribe will often ask themselves three questions:

- Is it more than job is worth
- Will I get caught
- Is it right or wrong? And if they do decide to pay a bribe they will not use their own money-they will use yours.

This typically means two things: firstly, there will be an incident of fraud in orer to create or hide the payments; and secondly, they will need to get someone else involved to circumvent internal controls.
Whilst the risk of fraud cannot be eliminated entirely, it can be greatly reduced with the right approach.

Establish the right culture

While paying bribes may be part of the business culture in some of our organizations, an organization that condones bribes will at some stage find itself in the regulatory or investor spotlight. Setting the right ethical tone within the organization is therefore vital. So too is communicating this tone to business partners. Country-specific codes of conduct and ethics policies are a must. They should be practical, easy to understand and easily accessible to every employee. The proactive development and promulgation of these policies by senior management will set the tone for what is deemed fraudulent or unethical behaviour, thereby facilitating the disciplinary process.

Hire the right people

Automated procurement and accounting systems produce information, but these processes are still driven by people. This is particularly the case in China where most data input is still done manually, providing an ideal environment for fraudulent behaviour. In order to minimize the amount of control each individual has over each business process, segregation of duties should be implemented so that no single individual is empowered to oversee the whole transaction. Hiring the right staff and providing suitable training is therefore imperative if processes are to work correctly.

Assess internal controls

To mitigate the risk of fraud, existing controls, thresholds and procedures should be questioned, since all too often foreign managers are simply told "this is the way it is done in this part of the world". They then leave it at that, until it goes wrong. To identify fraud one must understand risk. By identifying the risks within a control system, areas susceptible to fraud can be highlighted and corrected. However, even the most carefully designed and tightly controlled system can be circumvented. Fraud in the procurement process commonly occurs when controls are deliberately overridden, by either the individual who knows he will not be challenged, or a collusive group able to use its knwoledge to hide fraudulent activity.

Actively monitor controls

Having reviewed and enhanced internal controls there is little point in ignoring them. As business processes develop, so too should the systems that control them. An established control review procedure, which tests accuracy and functionality, is a must.

Develop a fraud response plan

The timing of a fraud cannot be predicted. It can rear its head at the most inconvenient times. Organizations should expect the unexpected and have a fraud response plan in place.

Know your supplier

Performing background checks and integrity due diligence can ensure that the manufacturer are of reputable standing as well as highlighting the manufacturer's interests, associations, related parties and possible conflicts of interest. Checking on the financial stability of each of the suppliers is also important, especially in the current economic climate. Ideally, this should include an examination of the supplier's financial records to ensure. It is in a stable financial position and is able to fulfill its contractual commitments. Ensuring that the supplier has the required capacity is also crucial.

Additionally, reviewing both payroll costs and employee numbers may highlight problems of underpayments, overstaffing, illegal overtime or child labour. Once selected, a supplier must be subjected to regular due diligence checks to ensure that it is complying with all its legal and regulatory requirements.

Manage your sub-contractors

As supply chains extend and margins are squeezed suppliers are often driven to more and more sub-contracting. Recent manufacturing scandals and the resulting mass product recalls demonstrate that unless an organization has visibility and control over this process the risks are enormous, with branded product liable to appear in the worst production facilities or substandard materials include in the production process. Monitoring the procurement process through regular checks on quality are a must, unannounced visits can often throw up a few surprises. Examining the number of rejections attributed to poor quality by each quality assurance, supervisor and factory can often highlight strange patterns with particular employees.

All too often the saying in China "heaven is high and the emperor is far away" is real. If a supplier is based in China, and is responsible for providing finished goods to a corporation based outside his country, the supplier may be able to operate with little or no oversight, taking advantage of various schemes that may be contrary to the interests of the buyer such as:

- Production of counterfeit goods
- Selling finished goods at reduce prices
- Offering bribes to government officials to avoid being sanctioned for non-compliance with regulatory requirements
- Producing fraudulent financial statements and tax evasion

Consequently, ensuring appropriate storage and distribution centres, setting them up is also important. By performing regular stock counts, there is less opportunity for them.

IV. Conclusion

In conclusion, if appropriate prevention and detection methods are not implemented, organizations may suffer loss of revenue and profit. Routine checks for non-deliveries, repeat deliveries for the same order and discrepancies between purchase orders and delivery are a few of the procedures needed to reduce fraud risks.
Prevention is always better than cure. The amounts paid to settle any claims resulting from exposed fraud will always be secondary to the loss of reputation and integrity that companies may suffer for being associated with

such claims. In order for these to be fully exploited, investors must exercise a degree of caution and approach each one with skepticism.

V. Recommendations

Having analyzed all the parameters involved in this paper recommendations are hereby given as follows to curb procurement frauds: that professional procurement experts should be employed to manage all procurement activities in organization as recommended by the public procurement act 2007.

That procurement activity in every organization be reviewed from time to time to avoid practice that has been so rampant in many organizations today.

That due process be followed in the award of any contract and that there should be prompt monitoring of such contract during implementation to ensure adherence to specification and quality control.

If all these are put in place it is believed that procurement fraud shall be drastically reduced if not totally eliminated.

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