

BROWN SMITH WALLACE
A MEASURABLE DIFFERENCE™

Effective Internal Controls for Vendor Management & Procurement
SIAAB 2018 Fall Government Auditing Conference

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Agenda

- 1 Key Vendor Performance Risks
- 2 Managing Vendor Procurement and Performance Risks
- 3 Conducting Vendor Performance Audit
- 4 Case Studies
- 5 Contract Procurement Fraud Schemes & Red Flags

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Key Vendor Performance Risks

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Reputation

- Vendors through their actions, or lack thereof, damages the reputation of the organization.
- Examples:
 - ✓ Construction contractor hired to design and construct a bridge fails to properly calculate vehicle weight during rush hour resulting in a collapse of the bridge and loss of life.
 - ✓ Food service organization contracted to provide meals to Senior citizens fails to follow proper food safety protocols as agreed to in the contract resulting in food poisoning.

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Performance

- Vendor fails to meet timelines and/or fails to perform in accordance with the terms of the contract.
- Examples:
 - ✓ Audit firm fails to provide opinion on audited financial statements by agreed to deadline resulting in inability to obtain financing.
 - ✓ Leasing company contracted to provide Police vehicles to a municipality fails to equip the vehicles in accordance with the terms of the contract.

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Compliance

- Vendor fails to comply with laws and regulations governing the performance of the contract.
- Examples:
 - ✓ Construction company contracted to build a new headquarters building does not obtain the proper City permits resulting in project delays.
 - ✓ Utility management company hired to manage and maintain the City electric utility fails to comply with EPA guidelines for pollution discharge as agreed to in the contract.

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Non-Conforming Goods or Services

- Vendor delivers goods or services that do not conform to the contract specifications.
- Examples:
 - ✓ Medical services provider hired to provide medical services for a correctional institution fails to maintain licensed nurses on site during agreed to hours.
 - ✓ Construction contractor upgrading an airport terminal substitutes inferior and cheaper carpeting than what was agreed to per the contract.

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Change Order Abuse

- Vendor increases the price or extends and expands the contract scope through the use of multiple change orders.
- Examples:
 - ✓ Consulting firm hired to assess organizational structure failed to understand the scope of the project and issues multiple change orders to increase their time on the project and related costs.
 - ✓ Construction company hired to provide highway repairs is having difficulty completing the project on time and issues multiple change orders to extend the contract deadline.

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Cost Mischarging

- Vendor charges the organization for costs (material or labor) that are not allowable, reasonable, nor allocable to the contract.
- Examples:
 - ✓ A Fire Safety company has two contracts with a municipality. One to provide fire safety equipment on a lump sum basis and the other to provide safety equipment testing and maintenance on a time and materials basis. To avoid exceeding it's agreed to lump sum price for safety equipment, the company charges the safety equipment under the time and materials contract.
 - ✓ Construction company agrees in the contract to lease equipment on a project and charge the rental fee to the client. Instead, the contractor charges the purchase price.

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Data Breaches

- Vendor, either intentionally or through the ineffectiveness of its information technology security and controls, mismanages critical organization or customer data.
- Examples:
 - ✓ Technology firm contracted to manage and protect customer data on their system has a data breach resulting in customer credit card information being stolen.
 - ✓ A medical group contracted with the State to provide counseling services to at risk children provides a client list to a pharmaceutical company.
- Disclosure Laws - require public disclosure of security breaches; In place or in process at Federal/State level
- Resources (Privacyrights.org/data-breaches; Breachlevelindex.com; others??)

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Managing Vendor Procurement and Performance Risk

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1. Vendor Management Policy & Framework

- Purpose – Establish guidelines for managing the lifecycle of vendor relationships including procurement, management and disposition of vendor services.
- Key components of a Vendor Management Policy:
 - Vendor Risk Assessment – Establish criteria (i.e., \$\$, criticality) as a basis for risk rating (critical vs non-critical vendors). Can drive the extent of the remaining vendor management components.
 - Vendor Selection Due Diligence – Evaluating the ability of the vendor to provide the product and services.
 - Contract Management – Addresses types of contracts, terms, conditions; contract negotiation; execution; contract termination, etc.
 - Vendor Oversight and Monitoring – Factors that determine the extent, type and frequency of oversight and monitoring

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2. Right to Audit Clause

- Every contract should have a "right to audit" clause in the terms and conditions.
- The "right to audit" clause provides:
 - ✓ The contractual and legal right to conduct an audit of vendor compliance with the contract.
 - ✓ Puts the vendor on notice that their records are subject to an audit and acts as a preventative control.
- The Association of Certified Fraud Examiners (ACFE) provides a sample "right to audit" clause that could be used as a starting point for developing your own. (Other organizations such as the American Institute of Architects (AIA), etc.)

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3. Employee Education

- Educate employees who play a role in vendor/contract relationships on the critical terms and conditions of each contract.
- Provide employees with an understanding of the risks as well as the knowledge and ability to review and question invoices, change orders and goods/service delivery as a way to better manage vendor relationships and their performance

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4. Internal Controls

- Ensure that your internal checks and balances have been designed and are operating effectively to protect your organization from errors or potential wrong-doing by outside third-parties.
- Key internal controls include:
 - ✓ Documented policies and procedures.
 - ✓ Selection committees and criteria.
 - ✓ Segregation of duties.
 - ✓ Supervisory controls.
 - ✓ Receiving controls.

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4. Internal Controls (cont...)

- ✓ Authorization/approval controls (*contract, change orders, invoices, payment applications, etc.*)
- ✓ Reconciliation controls.
- ✓ Recording controls.

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5. Assign a Contract Monitor

- Assign an employee the role of contract monitor
- Duties should include:
 - ✓ Identifying critical terms, compliance requirements, scope, timelines and deliverables
 - ✓ Assessing and monitoring the risks in the contract
 - ✓ Establishing processes and internal controls to manage the risks
 - ✓ Monitoring contract compliance, progress and timelines
 - ✓ Ensuring goods/services are delivered in accordance with the contract
 - ✓ Periodically evaluating the contractor's financial condition and review available audit reports
 - ✓ Monitor changes in key contractor personnel
 - ✓ On sight inspections

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6. Audit Activities

- Exercise the "right to audit" clause by:
 - ✓ Including contract audit responsibilities within the scope of your Internal Audit function.
 - or-----
 - ✓ Periodically contract with outside parties to audit contracts for compliance and performance.

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6. Audit Activities (cont...)

- Service Organization Control (SOC) Reports (Formerly SAS-70)
 - SOC 1; SOC 2; and SOC 3
 - SOC 2 – Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality or Privacy
 - SOC 2 reports are intended to meet the needs of a broad range of users that need detailed information and assurance about the controls at a service organization relevant to security, availability, and processing integrity of the systems the service organization uses to process users' data and the confidentiality and privacy of the information processed by these systems. These reports can play an important role in:
 - i. Oversight of the organization
 - ii. **Vendor management programs**
 - iii. Internal corporate governance and risk management processes
 - iv. Regulatory oversight

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Conducting a Vendor Performance Audit

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Approach

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graph TD; A[Vendor/Contract Identification & Assessment] --> B[Audit Planning]; B --> C[Audit Execution]; C --> D[Reporting]; D --> A; subgraph C [Audit Execution]; C1[Compliance Review]; C2[Payment Review]; C3[Change Order Review]; end
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Contract Identification & Assessment

- Identify key vendors and third-party contracts.
- Identify risk factors. Ex:
 - Business criticality
 - \$\$\$\$
 - Performance history
- Assess contract risks.
- Identify contracts to audit.
- Develop contract audit schedule.

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Contract Audit Planning

- Review selected contract and identify:
 - ✓ Scope of work.
 - ✓ Terms and conditions.
 - ✓ Applicable laws and regulations.
 - ✓ Payment terms.
- Develop an audit plan focused on:
 - ✓ Compliance
 - ✓ Payments
 - ✓ Performance
 - ✓ Change Orders

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Audit Execution - Compliance Review

- Review vendor compliance with terms and conditions as well as applicable laws and regulations, for example:
 - ✓ Insurance.
 - ✓ Prevailing wage.
 - ✓ Diversity.
 - ✓ Bonding.
 - ✓ Lien waivers.
 - ✓ Permits.
 - ✓ Taxes.
 - ✓ Etc.

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Audit Execution - Payment Review

- Review vendor invoices/payments for:
 - ✓ Compliance with contract terms.
 - ✓ Appropriateness of labor, material, equipment, insurance, taxes, markups and other charges.
 - ✓ Adequacy, accuracy and completeness of support.
 - ✓ Duplicate and/or inappropriate charges.
 - ✓ Integrity, accuracy and appropriateness of subcontractor invoices.
 - ✓ Proper and timely payments to subcontractors.
 - ✓ Appropriateness of retainage (if any).

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Audit Execution - Performance Review

- Review key performance criteria based on contract specifications and deliverables, for example:
 - ✓ Material specifications.
 - ✓ Level/expertise of labor.
 - ✓ Quality of deliverables.
 - ✓ Delivery timelines.

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Audit Execution - Change Order Review

- Review change orders for compliance with contract terms and accuracy, for example:
 - ✓ Change orders appropriate.
 - ✓ Change orders priced correctly.
 - ✓ Change orders not duplicative.

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Reporting

- Report back to management on issues and make recommendations to resolve.

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Case Studies – Risk Became Reality

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Fraudulent Vendors

- A school district technology coordinator created a list of nine fake vendors as part of a fraudulent billing scheme that netted nearly \$420,000.
 - The suspect lined up 9 individuals to pose as school district vendors and had checks delivered to a PO BOX he opened in another city
 - The coordinator forged the names of the vendors on the checks and countersigned his own name, and deposited into his account
- What measures could the school district had taken to prevent/detect this fraud?

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Inflated Charges

- A supplier inflated prices above the agreed upon pricing to the U.S. government by \$48M for food supplies and water to be provided to troops serving abroad.
 - ✓ The supplier did this by using a company it controlled as a middleman to mark up prices and to obscure the inflated prices
- What measures could the US Government had taken to prevent/detect this fraud?

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Construction Sub-Contractor

- While on a project to build a water treatment plant for a State agency, the sub-contractor prepared and submitted inflated invoices and false change orders for labor and materials provided to the project, which resulted in \$4.8 million in overbilling.
- What measures could the State Agency had taken to prevent/detect this fraud?

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Fire Safety Company

- A City government contracted with a fire safety company to annually inspect and re-size firefighter safety equipment, but failed to perform this critical function, putting the safety of firefighters in jeopardy.
- What measures could the City had taken to prevent/detect this noncompliance?


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Contract Procurement Fraud Schemes & Red Flags

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Contract Procurement Fraud Categories

- Collusion among contractors to circumvent the competitive bidding process.
- Collusion between contractors and procurement employees.



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Collusion Among Contractors

Schemes

- **Complimentary Bidding** – competitors submit token bids to influence contract price and award.
- **Bid Rotation** – competitors conspire to alternate the business between them on a rotating basis.
- **Bid Suppression** – competitors enter into an illegal agreement whereby at least one refrains from bidding or withdraws a previously submitted bid.
- **Market Division** – competitors enter into agreements to divide and allocate markets and agree not to compete in each others markets.

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Collusion Among Contractors

Red Flags

- Limited competition.
- Winning bid appears too high.
- All contractors submit consistently high bids.
- Qualified contractors do not submit bids.
- Winning bidder subcontracts to losing bidder or non-bidders.
- Bids submitted by companies unqualified to do work.
- Bids fail to conform to requirements of the solicitation.
- Losing bids poorly prepared.
- Fewer competitors than normal submit bids.

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Collusion Among Contractors

Red Flags (cont.)

- Bid prices fall when new contractor enters the competition.
- Rotational pattern to winning bidders.
- Evidence of collusion in bids, for example:
 - Bidders make same mathematical or spelling errors.
 - Bids prepared using same format or typeface.
 - Bidders submit identical bids.
- Pattern where last party to bid wins the contract.
- Patterns of conduct that suggest collusion, for example:
 - Subcontract with each other.
 - Regularly socialize.
 - Hold meetings or visit each others offices.

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Collusion Between Contractors & Employees

Schemes

- **Need Recognition** – employee convinces employer that it needs excessive or unnecessary products or services.
- **Bid Tailoring** – employee drafts bid specifications in a way that gives unfair advantage to a certain contractor.
- **Bid Manipulation** – employee manipulates the bidding process to benefit a favored contractor.
- **Leaking Bid Data** – employee leaks pre-bid information or confidential information from competing bidders to a favored bidder.

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Collusion Between Contractors & Employees

Schemes (cont.)

- **Bid Splitting** – employee breaks up a large project into several small projects that fall below the mandatory bidding level.
- **Unjustified Sole Source Award or Other Noncompetitive Method of Procurement**

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Collusion Between Contractors & Employees

Red Flags

- **Need defined in a way that can only be met by a certain contractor.**
- **Assessment of need is not adequately or accurately developed.**
- **Services continually purchased from a single source.**
- **Estimates not prepared or are prepared after solicitations requested.**
- **Employee displays sudden wealth or lives beyond means.**
- **Employee has outside business.**
- **Multiple purchases that fall below the threshold limit.**
- **Weak controls over the bidding process.**
- **Only one or a few bidders respond to bid requests.**
- **Contract not re-bid even though fewer than minimum number of bids received.**

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Collusion Between Contractors & Employees

Red Flags (cont.)

- **Similarity between specs and winning contractor's product/service.**
- **Bid specs are tailored to fit products or capabilities of a single contractor.**
- **Unusual or unreasonable narrow or broad specs for the type of goods or services being procured.**
- **Unexplained changes in contract specs from previous proposals.**
- **Higher number of competitive awards to one supplier.**
- **Socialization or personal contacts between contracting personnel and bidders.**
- **Specs developed by or in consultation with a contractor who is permitted to compete in the procurement.**

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Collusion Between Contractors & Employees

Red Flags (cont.)

- High number of change orders for contractor.
- Evidence of changes to bids after received.
- Winning bid voided for errors and job re-bid or awarded to another bidder.
- An otherwise qualified bidder is disqualified for seemingly arbitrary, false, frivolous, or personal reasons.
- Employee accepts late bids.
- Contract awarded to non-responsive bidder.
- Bids of competing contractors are lost.
- Bid deadlines are changed.
- Invitations for bids are sent to unqualified contractors or those who previously declined to bid.

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Collusion Between Contractors & Employees

Red Flags (cont.)

- Winning bid is just under the next lowest bid.
- Winning bid is unusually close to the procuring entity's estimate.
- Last party to bid wins the contract.
- Contractor submits false documentation to get a late bid accepted.
- Contracting personnel provides information or advice about contracts to a contractor on a preferential basis.
- Unjustified split purchases that fall under the competitive bidding limits.
- Sequential purchases just under the upper-level review or competitive bidding limits.
- Frequent use of sole source procurement contracts.

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Collusion Between Contractors & Employees

Red Flags (cont.)

- High number of sole source awards to one contractor.
- Requests for sole source when there is an available pool of contractors.
- Procuring entity did not maintain accurate minutes of pre-bid meetings.
- False statements made to justify noncompetitive method of procurement.
- Justifications for noncompetitive method signed/approved by employees without authority.
- Fail to obtain required review for sole source justification.

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Recap and Open Discussion



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