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Vendor Relationships and Procurement Fraud

November 2010

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Procurement fraud occurs when an employee or other person related to a firm unlawfully gains an advantage in purchasing goods or services for that firm. Some of the more common types of procurement fraud are overpaying for products (and receiving kickbacks), creating and falsely paying duplicate vendors, creating and paying fictitious vendors, and paying for over-shipments from vendors.

Procurement fraud can be a difficult fraud to uncover – the only accounting entries to detect it will likely represent legitimate transactions between the company and its vendors. Make no mistake, however – it is a costly fraud that can result in untold losses for companies that choose to deny its existence or refuse to implement fraud-related controls to help prevent it.

Improper vendor relationships are at the center of many frauds perpetrated in corporate purchasing departments. Consider the case that involved a manufacturing company that consistently overpaid for commonly used office equipment. We found that the Purchasing Manager had a close personal relationship with the vendor who supplied the office equipment – in fact, the Purchasing Manager and vendor had worked together earlier in their careers!

Given the proliferation of social networking sites, it didn't take long to discover the prior relationship. No one at the company, however, seemed to have any knowledge about the prior relationship, much less an appreciation for the obvious conflict it created for the Purchasing Manager. And the accounting department simply processed the invoices each period without questioning why the equipment was so outrageously priced. Because there actually WERE equipment shipments to the company (again, legitimate transactions), everyone from accounting to receiving just accepted the situation and assumed that someone else had asked the tough questions about pricing.

Purchases by company employees who have personal relationships with outside vendors should automatically be subject to greater scrutiny solely because of those personal relationships – they create a conflict of interest for the company employee who is involved in one, and should be regularly monitored. If a personal relationship exists between an employee who has purchasing authority and one of the company's vendors, it makes sense to assign invoice review and approval authority to someone other than the conflicted employee. At the same time, management should also review purchases on a periodic basis to ensure that expenses are reasonable in comparison to other departments and prior years.

One more point about the company: it appeared that the Purchasing Manager had carte blanche to approve ALL types of purchases, not just manufacturing-related ones. Proper segregation of duties dictates that purchases should be approved first by the departments that need those items (and processed by accounts payable), and those purchases should be approved by someone at least one level above the purchaser. It's easy to understand why the fraud continued to occur; there were insufficient checks and balances in the purchasing process of the organization.

In addition to the overpayments just discussed, duplicate payments can result from improper company-vendor relationships. Duplicate payment problems can occur when purchasing and/or AP sets up the same vendor with slightly different names, providing the opportunity for dishonest employees set up additional vendors and make payments to either party or make duplicate payments to the same party. Keep in mind, however, that duplicate payments can occur unintentionally, for example, purchasing and/or AP unknowingly sets up a vendor in one database while that vendor has already been set up in another company database. Purchasing and/or AP may also inadvertently set up the same vendor in the vendor database with slightly different names – ABC, Inc. and ABC Corporation for example.

Proper new vendor controls are essential for preventing such problems, whether deliberate or intentional. Companies should ensure proper segregation of duties by verifying that people charged with paying invoices do not have the authority to set up payees, and employees approving purchases are not charged with cutting checks as well. Appropriate payment approval levels are a must also – approval authority should only be granted to employees authorized to enter into transactions for the company, and the company's board of directors should dictate those authority levels.

Another problem that can occur involves fictitious vendors. Without proper controls in place, AP employees in particular may have the ability to set up a new vendor and process payments for that vendor. Suppose an AP clerk, John Smith sets up a vendor named JS Incorporated that sells miscellaneous supplies generally purchased with no purchase order. John can create an invoice for $250 and mail it to the Company knowing that as the AP Clerk he will be the employee who processes the payment. If John alters the invoice with checkmarks, etc. to make it appear that the invoice was approved, and presents it as support to get the check signed, there are many controllers and CFOs who won't think twice about paying that $250 invoice.

To help mitigate the risk of fictitious vendors, be sure to have someone other than the requestor verify the existence of the vendor by performing several tasks such as running a D&B report on the vendor, searching the state corporations database, or searching for the company' website, among others.

Improper vendor relationships can further result in vendors over-shipping products to increase their revenues. Employees who have prior relationships with vendors may be tempted to enable those vendors to sell products or services to a company that it didn't order and doesn't need. It's important to verify relationships with vendors, for example, whether there are employees who previously work for vendors, or former employees who have been hired by one of your company's vendors.

In extreme cases, employees have been found to receive kickbacks from vendors for paying for vendor over-shipments. If such types of vendor relationships exist, it's best to ensure that non-conflicted employees are involved in the purchasing process – in either an approval authority capacity or check signing capacity.

There are several steps you can take to help ensure that your company's vendor relationships are appropriate and not conducive to procurement fraud. Some of those steps are as follows:

- Perform search for duplicate payments each year
- Compare vendor names and addresses to employee records on at least an annual basis or when adding new vendors
- Perform a vendor verification search if it hasn't already been done for each vendor
- Compare employee SSNs to the master death records made available by the SSA – each year or upon hire for new employees
- Perform surprise audits – for example, select several payments per month and audit the details of each transaction, verify the existence of each vendor, and review cancelled checks for endorsements, etc.
- Review company credit card expenses for inappropriate purchases. Employees might purchase personal items or pay exorbitant prices for meals, supplies, etc., especially when they are using company money rather than their own funds.
- Review the company's purchasing and receiving processes, and ensure that there are key controls that mitigate the risk of fraud throughout the processes

Procurement fraud is a real and potentially costly problem for companies. Although there is no guarantee fraud will not occur, proper controls and periodic audits and reviews of processes can help reduce the chances that it will occur.

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