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Fraud Prevention and Detection 2009 Improving  
Accountability for Government Professionals Conference

## **Fraud Indicators and Red Flags in the Procurement Process**

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June 3, 2009



# What Is Fraud?

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- Fraud is the misrepresentation of a material fact with the intent to deceive and includes
  - Deliberate omission of material facts
  - Reckless disregard for the facts

**–Look for the lie!**



# Who Commits Fraud?

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People who commit fraud can be:

- Employees or Management
- Contractor Personnel or Government Employees

Companies can be held responsible for their employees and managers





# Procurement Fraud Schemes and Indicators

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- A procurement fraud scheme is a
  - Method or plan aimed at defrauding the Government
  - Indicators are a clue or hint that an activity or event requires a closer examination
    - Signal or clue that a contractor or Government employee may be engaging in fraudulent conduct
    - Red Flags are things that stand out – “get your attention”



# Common Procurement Fraud Schemes

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- Bribery and Kickbacks
- Conflicts of Interest
- Rigged Specifications
- Collusive Bidding
- Excluding Qualified Bidders
- Leaking Bid Data
- Manipulation of Bids
- Unjustified Sole Source
- Cost Mischarging
- Defective Pricing
- Co-mingling of Contracts
- Phantom Vendor
- False Statements & Claims



# Common Procurement Fraud Schemes

## Quality Control Fraud

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- Product Substitution
- Counterfeit Parts
- False Testing
- False / Inaccurate Documentation



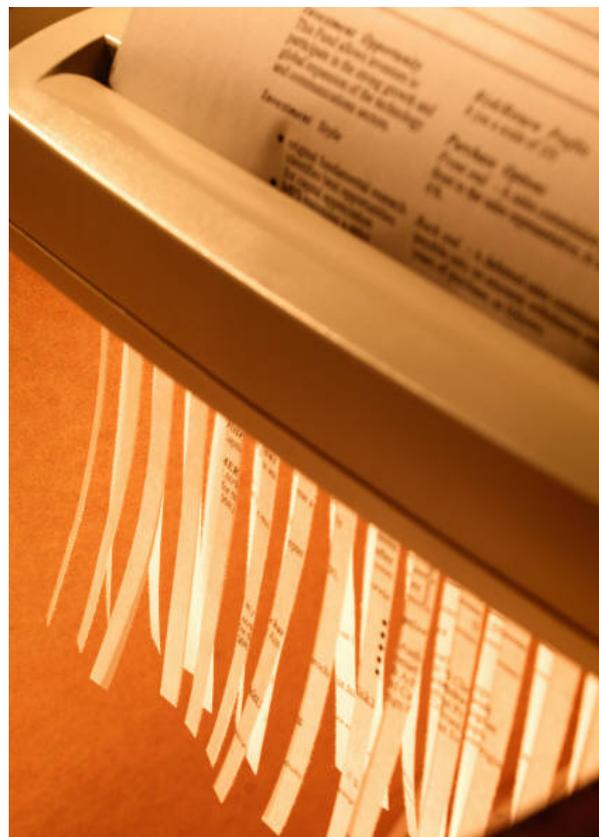


# Common Procurement Fraud Schemes

## Pricing / Cost Fraud

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- **Asset Misappropriation**
  - Larceny, Theft, Embezzlement
  - Check Tampering
  - Billing Schemes
  - Payroll Schemes
  - Travel and Expense Schemes
  - Inventory and other Assets





# Fraud Indicators in the Procurement Process

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## **Phase 1: Identifying the Need or Requirement**

Defining requirements improperly

## **Phase 2: Pre-Solicitation Stage**

Conflicts of interest, Restrictive conditions, advance information, splitting

## **Phase 3: Solicitation**

Selective release of information, anti-competitive activity

## **Phase 4: Proposal Phase**

Bid rotation, Change-order schemes, Defective Pricing

## **Phase 5: Fraud in Contract Negotiation**

Disclosure of information resulting in a competitive advantage

## **Phase 6: Award**

Poorly written source selection, Misrepresenting capabilities

## **Phase 7: Contract Performance and Administration**

Faulty Inspection reports, Labor Mischarging, Billing System



# Fraud Indicators and Red Flags in the Procurement Process



## Phase 1: Identifying the Need or Requirement

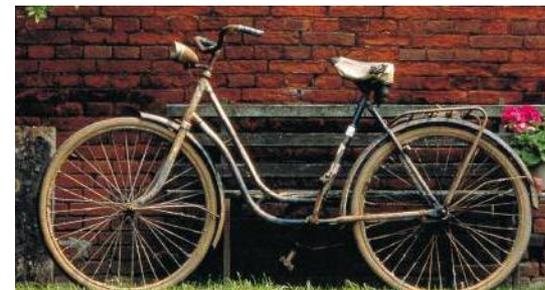
### Example:

Decision to buy goods and services in excess of those actually needed and/or from selected sources

### Fraud Indicators/Red Flags:

- Defining requirements improperly so that only certain contractors qualify
- Identifying time frames as critical when requirements are of questionable urgency

### What was Needed:



### What was Solicited:





# Fraud Indicators and Red Flags in the Procurement Process



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## Phase 2: Pre-Solicitation Stage

### Example:

Collusion between government and contractor personnel to write restrictive or vague specifications



### Fraud Indicators/Red Flags:

- Contractor involvement in writing of specifications without proper precautions concerning conflicts of interest
- Statements of work and specifications designed to fit products or capabilities of single contractor
- Government employee provides contractor with advance information or advice on a preferential or selective basis
- Splitting requirements to lower the cost to avoid supervision and oversight



# Fraud Indicators and Red Flags in the Procurement Process

## Phase 3: Solicitation

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### Examples:

- Activities that diminish use of competition and keep government from obtaining goods and services at the best value
- Collusive bidding, kickbacks, or other anti-competitive activity

### Fraud Indicators/Red Flags:

- Excessive personnel or geographic limitations
  - Falsification of certifications (i.e. minority or woman owned)
  - Excessive use of a single contractor in a competitive field
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- Not adequately publicizing the procurement
  - Government contracting or program personnel socializing with successful contractors
  - Contracting or program personnel “recommending” a particular supplier or subcontractor
  - Misrepresenting/ making false statements during the pre-award survey



# Fraud Indicators and Red Flags in the Procurement Process

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## Phase 4: Proposals

- **Bid rotation:**

- **Fraud Indicators/Red Flags:**

- All contractors involved submit bids but agree to take turns on being the low bidder
    - A pattern for getting the award
    - Successful bidders agree to use other participating contractors as subcontractors.

- **Sporadic bidding:**

- **Fraud Indicator/Red Flag:**

- One or more competitors agree to refrain from bidding or agree to withdraw a previously low bid



# Fraud Indicators and Red Flags in the Procurement Process

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## Phase 4: Proposals Continued

- **Token bids:**

  - **Fraud Indicator/Red Flag:**

  - Competitors submit bids that are too high to be acceptable to create the appearance of genuine competition.  
(AKA “complimentary” or “shadow” bidding)

- **Market allocation:**

  - **Fraud Indicators/Red Flags:**

  - Contractors agree not to compete in designated parts of the market.
  - **Change-order schemes:** Contractor submits a low bid to assure receiving the award while anticipating change orders (contract modifications) to be issued during the life of the contract



# Fraud Indicators and Red Flags in the Procurement Process

## Defective Pricing



- Proposed and actual costs vary significantly
  - Part of the Truth in Negotiation Act (TINA)
  - Mistakes are different than lies

**Detected  
during  
performance**

### Fraud Indicators/Red Flags:

- Falsifying data submitted to support a proposal
- Channeling work to a company created to increase prices
- Failing to identify and pass on actual prices
- Out-dated standard costs or indirect cost rates are used



# Fraud Indicators and Red Flags in the Procurement Process



## Phase 5: Fraud in Contract Negotiation

### Example:

- Disclosure of information resulting in a competitive advantage to one contractor over others

### Fraud Indicator/Red Flag:

Information given to one contractor that is not given to others which give that contractor a competitive advantage

### Boeing probe intensifies over secret Lockheed papers

By David Bowermaster  
*Seattle Times aerospace reporter*

When Boeing fired a 60-year-old engineer named Ken Branch in 1999, he was cited for possessing proprietary Lockheed Martin rocket data in violation of company policy.

Boeing and Lockheed were rival contenders for an enormous Air Force rocket program that both considered key to their future military and space prospects. And Branch, who had previously worked for Lockheed, apparently brought the documents with him when he joined the competition. Despite the intense rivalry over the rocket program, Boeing promptly alerted



enlarge THOM BAUR, BOEING / VIA BLOOMBERG NEWS, 2003

A Boeing Delta IV rocket launches from Cape Canaveral, Fla., on March 10, 2003. Later that year, the Air Force stripped Boeing of seven launches worth \$1 billion and reallocated them to Lockheed due to a growing scandal over alleged industrial espionage.



# Fraud Indicators and Red Flags in the Procurement Process



## Phase 6: Award

### Example:

Activities that compromise evaluation of the proposal

#### Past Performance Evaluation

- Technical Performance: **POOR**
- Contract Management: **POOR**
- Cost Performance: **POOR**

**RESULT: CONTRACT AWARD**

### Fraud Indicators/Red Flags:

- Poorly written source selection that does not adequately justify award
- Favoritism or bias in proposal, evaluation, or contract award
- Awards to contractors with poor histories of past performance or inadequate evaluation of a contractor's present responsibility
- Misrepresenting a firm's capabilities / qualifications
- Failure to fully disclose required information
- Disqualification of any qualified offeror without proper justification
- Indication that contractor submitted false claims or false cost or pricing data



# Fraud Indicators and Red Flags in the Procurement Process



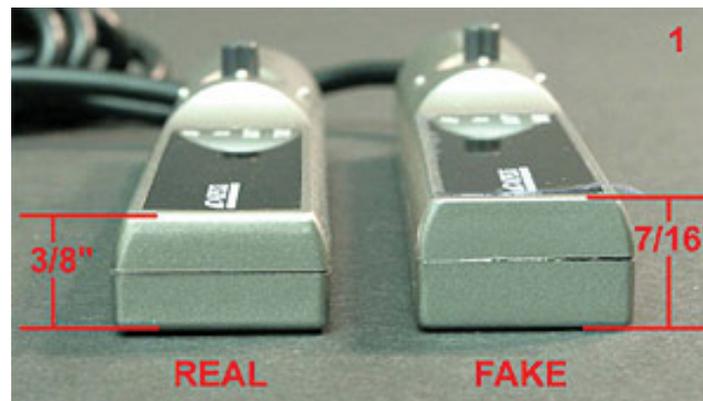
## Phase 7: Contract Performance and Administration

### Examples:

- Product Substitution
- Cost Mischarging
- Progress payment fraud

### Fraud Indicators/Red Flags:

- Serial numbers missing
- Inspection reports that appear altered by whiteouts
- Requests for payment that are inconsistent with earlier cost history
- History of frequent invoice/voucher errors, poor documentation, & claiming unallowable costs
- Little or no physical progress on the contract even though significant costs have been billed



Source: Genuine-Performance.com News Alert



# Cost Mischarging Example



NEWS  
RELEASE

For Immediate Distribution

CONTACT:  
Secretary of Defense Office of Inspector General

NORA M. MANELLA  
United States Attorney  
Central District of California

#94-121  
July 14, 1994

Howard Daniels, AUSA  
(213) 894-2264

## LITTON PAYS THE UNITED STATES \$82 MILLION

United States Attorney Nora M. Manella announced today from Beverly Hills based Litton Systems, Inc. (a subsidiary of Litton Industries, Inc.) has agreed to pay the United States \$82 million to settle a Civil Fraud Case. The case was originally filed in 1988 by a whistleblower under the False Claims Act; after investigation of the claims, the United States intervened in the case and took over the litigation.

Assistant United States Attorney Howard Daniels, who handled the case, explained that the government claimed that Litton systematically shifted costs for data processing from its commercial customers to Pentagon contracts. This was done through a complex computerized accounting system, the effect of which was to charge the government as much as ten times more for the same work as Litton charged its commercial customers. This practice occurred from 1981 until 1989, when the United States won a court order ruling the practices were illegal and in violation of Litton's contracts with the Department of Defense.

The United States contended that Litton managers lied to government auditors and that Litton knowingly filed false papers with the government to conceal its unlawful accounting practices.

This case was filed originally under the guidelines provisions of the False Claims Act by Taxpayers Against Fraud and Jim Canton, a former Litton employee who was a technical director, in U.S. District Court in Los Angeles, where Litton is based.

Under the guidelines provisions, a private party may file a suit on behalf of the federal government and receive a portion of the settlement if the government takes over the case and is successful in its prosecution.

Assistant United States Attorney Daniels emphasized that the successful prosecution of the case was aided by the Defense Contract Audit Agency, Defense Logistics Agency, and the Air Force Office of Special Investigations.

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## Litton Systems

- Systematically shifted costs for data processing from commercial customers to government contracts through complex computer accounting system
- Resulted in charging the government 10 times more than commercial customers
- Concealed illegal accounting practice through false statements
- Resulted in \$82 million settlement



# Product Substitution Example

## Quality Control Fraud



DEFENDANT PLEADS GUILTY TO FALSIFYING TEST REPORTS OF METALS FOR USE IN SPACE PROGRAM

January 19, 2007

FOR IMMEDIATE RELEASE

- Subcontractor sold metal for use in NASA's orbiter fleet and critical ground support equipment
- Test results and specs did not conform with purchase order requirements, so Subcontractor altered:
  - Metal testing labs test cert's
  - Mill reports from metals OEM
  - Cert's of Compliance from metal distributors





# Contract Performance Phase

## Labor Mischarging

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- Most significant cost charged to Government contracts
- Most difficult area to review
- Critical that time is properly charged to the project actually worked on

### Red Flags:

- No third party documentation
- Ghost employees
- Unusual variations
- Billings different than source records
- Timecard alterations
- Failure to record all time worked
- Consistent patterns
- Unreasonable patterns
- Large number of proposals without corresponding bid & proposal costs

Most important control in the labor accounting system is the **individual employee**



# Contract Performance Phase

## Other Cost and Billing Issues

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- Material Mischarging
  - Similar to Labor mischarging
  - What would you expect?

### Red Flags

- Double counting costs as both direct or indirect rates
- For professional and consulting fees, there is no formal signed agreement but there are large sums charged for “services rendered” based on invoices with few specifics.



# Contract Performance Phase

## Billing System

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- Bill for goods or services not performed
  - Work not done
  - Supplies not delivered
  - Items that are delivered in short quantities

### Red Flags

- Supporting documents missing or unavailable for review



# Contract Performance Phase

## Product Substitution

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- Product substitution includes all deliverables of goods and services that do not conform to minimum, mandatory **contract specifications**
- Red Flags
  - Field test results in a significant number of failures
  - Missing or altered labels
  - Unauthorized changes



# Contract Performance Phase

## Quality Control Issues



### Red Flags:

- Lack of time to test for the amount of equipment or parts to be tested
- Questionable testing claims
- Altered test reports
  - Minor discrepancies in typeface
  - “White out” sections
  - Handwritten portions of typed documents
- Non-operating test equipment
- Part failures after “100% Inspection and Testing”
- Subsequent test and inspection failures on products in performance-based contracts
- Commingled tested and untested items



# Contract Performance Phase

## Quality Control Issues



### Red Flags:

- Limited government access to production and storage facilities
- Unwillingness to mark or seal in presence of government representative
- Contractor efforts to hide records



Source: Army



# Conflict of Interest - General Definition

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- Person with procurement responsibilities having an UNDISCLOSED personal financial interest
- Presents a conflict between the individual's private interests and public interest of the U.S.



# Public Corruption Example

## Cashing In For Profit?

Who Cost Taxpayers Billions In Biggest Pentagon Scandal In Years?

Jan. 5, 2005



(CBS) Chances are you've never heard of Darleen Druyun, but she's been spending a lot of your money — your tax money.

For 10 years, Druyun was the Air Force official who decided how much to pay for bombers, fighters, missiles -- you name it. She had such a reputation for toughness, she was commonly known as "The Dragon Lady." Which is why there is shock that Druyun, one of the most powerful women in Washington, is headed to prison.

For a decade, Darleen Druyun was in charge of deciding how much to pay for bombers, fighters and missiles used by the Air Force. (CBS)

## Over 1,000 Gov Employees Snared by FBI for Corruption

Wow. The magnitude of public corruption uncovered by the FBI so far is astounding. Part of [FBI Director Robert Mueller's statement before the Senate Judiciary Committee](#):

Friday, September 15, 2006

**Administration Oversight, Open Government**

## Restoring Honesty and Accountability in Washington

Over the last five years, public confidence in the federal government has plummeted. Growing

In the biggest Pentagon scandal in 20 years, it appears that billions of dollars were doled out to the Boeing Company, as Druyun was accepting personal favors for her family.

Now, as **Correspondent Scott**



# Conflict of Interest - Examples

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- Diversion of resources to personal business
- Financial interest in a supplier or contractor
- False vendors
- Purchases through a pass through business owned by the employee
- Receipt of inappropriate gifts from vendors
- Negotiates or accepts employment from a vendor or contractor



# Conflict of Interest - Examples

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- Using public office for private gain
- Impeding Government efficiency or economy
- Giving preferential treatment to any person or entity
- Making Government decisions outside official channels
- Exertion of an employee's influence to the detriment of the agency
- Romantic and personal relationships with vendors
- Doing business at "less than arms length"



# Conflict of Interest - Statutes

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- 18 USC 203 (Compensation to Members of Congress, officers, and others in matters affecting the Government)
- 18 USC 207 (Restrictions on former officers, employees, and elected officials of the executive and legislative branches)
- 18 USC 208 (Acts affecting a personal financial interest)
- 18 USC 209 (Salary of Government officials and employees payable only by United States)
- 41 USC 423 (Procurement Integrity Act)



# Conflict of Interest - Regulations

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- 5 CFR Part 2635 (Standards of Ethical Conduct for Employees of the Executive Branch)
- 5 CFR Part 2641 (Post Employment Conflict of Interest Restrictions)
- 5 CFR Part 2640 (Interpretations Exemptions and Waiver Guidance Concerning 18 USC 208)
- FAR Part 3
- DFAR Supplemental Part 203
- DOD DIR 5500.7R (Joint Ethics Regulations)



# Fraud Indicators and Red Flags

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- Unexplained or unusual favoritism for a particular contractor or vendor
- Payment of unjustified high prices
- Purchase of unnecessary or inappropriate goods or services
- Continued acceptance of high priced, low quality goods



# Fraud Indicators and Red Flags

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- Employee appears to be living beyond their means
- Failure to file Financial Disclosure Forms
- Interest by the employee in a particular vendor
- Employee declines promotions from a procurement position



# Fraud Indicators and Red Flags

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- Employee discusses or negotiates for employment with a current or prospective vendor
- Close socialization with and acceptance of inappropriate gifts from a vendor
- Employee has an undisclosed side business
- Vendor and employee addresses, phone numbers match



# Fraud Indicators and Red Flags

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- Vendor address is a PO Box or a mail drop
- Improper change orders on a contract
- Multiple purchases under the bid limit
  - Split purchases to keep award out of competitive bidding
- Payment without invoices



# Questions?

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