Purchasing System – Circumventing Internal Controls as Fraud Indicators

The Scenario

A contractor, headquartered in Washington, D.C., provides services worldwide. The contractor generates 80 percent of its sales from contracts with the United States Government. DoD contributes 80 percent of the sales for a flexibly priced contract. The contractor performs 100 percent of the flexibly priced contract in a war zone. The contractor has adequate policies and procedures for all of its practices including the purchasing and accounts payable functions. The policies and procedures apply to the entire company. The administrative contracting officer approved the contractor's purchasing system in accordance with the Federal Acquisition Regulation (FAR) Part 44.305, "Subcontracting Policies and Procedures, Granting, Withholding, or Withdrawing Approval," requirements.
FAR Part 44.305 states, in part, that the cognizant ACO [administrative contracting officer] is responsible for granting … approval of a contractor's purchasing system and that the ACO shall approve a purchasing system only after determining that the contractor's purchasing policies and practices are efficient and provide adequate protection of the Government's interest. Additionally, based on transactions initiated in the United States, the auditors found that the contractor consistently followed their policies and procedures.

While performing the risk assessment for the contractor's incurred cost audit, the auditors identified one high-risk DoD flexibly priced contract – the contract performed in the war zone. The auditors determined that the subcontract costs are 60 percent of the contractor's cost incurred on the contract, a potential fraud indicator. The auditors queried the company officials about the circumstances surrounding the subcontract award. The officials said that the contract required the company to staff the contract immediately after signing. Therefore, the contractor deployed a volunteer, the Purchasing Director, to staff the contract in the war zone. However, due to the contractor's lengthy procurement process, the official explained that the Purchasing Director decided to issue a $50,000 purchase order, the authorized signature level for the position, and later planned to award the subcontract in accordance with the contractor's policies and procedures.

Despite some skepticism, said the official, the company officials agreed with the Purchasing Director's plan to initially staff the office, in the war zone, by issuing a $50,000 purchase order. The Purchasing Director found a subcontractor for the job. Happy to get the work, the subcontractor's official told the Purchasing Director that he would give the contractor a 20-percent discount. The purchase order, intentionally silent as to the 20-percent discount, instructed the subcontractor to submit all invoices to the contractor's headquarters in Washington, D.C. The Purchasing Director distributed the original purchase order to the subcontractor and forwarded a copy to the company.

The subcontractor performed on the $50,000 purchase order and submitted its first invoice to the contractor for $30,000. The subcontractor submitted another invoice for $50,000. At the contractor's Accounts Payable Department, the clerk observed that the subcontractor had submitted invoices totaling $80,000 on a $50,000 purchase order. Concerned about having neither a purchase order nor a subcontract for the aggregate amount invoiced, the clerk communicated with the Accounts Payable Director who then contacted the Chief, Financial Officer for advice.

The Chief Financial Officer contacted the Purchasing Director, a long-time friend and co-worker. The Purchasing Director had often expressed a desire for a more lavish lifestyle for his family. The Purchasing Director explained that the subcontractor continued to provide the services described in the purchase order. The official said that the Purchasing Director did not initiate the solicitation process for awarding the subcontract as originally planned and as the contractor's policy required. The official further explained that the Purchasing Director emphasized his desire to retain subcontract continuity on the contract. The official stated that the Purchasing Director pleaded with the Chief Financial Officer to modify the purchase order and pay the subcontractor's invoices as submitted. The Chief Financial Officer agreed. He trusted his friend to make sound business decisions for the company. Afterwards, the Chief Financial Officer advised the Accounts Payable Director that he approved the purchase order modification practice for processing the subcontract's invoices.

As a result of the auditors' inquiries, the auditors identified another potential fraud indicator caused by the contractor officials circumventing the Accounts Payable and Purchasing Department's internal controls. Also, the auditors confirmed that the Chief Financial Officer's purchase order modification practice and the payment of the subcontractor's invoices circumvented internal controls. In the incurred cost audit, the auditors questioned the
$70 million dollars (less the $50,000 original purchase order amount) that the contractor paid the subcontractor. The auditors questioned the subcontract costs in accordance with FAR 31.205-33, "Professional and consultant service costs," regarding the lack of a subcontract agreement. FAR 31.205-33(d)(8) states, in part, that in considering the allowability of the costs, the contracting officer shall consider the adequacy of the contractual agreement for the services. In addition, the auditors referred the matter for investigation. The investigators found that the Purchasing Director received a 20-discount on each of the subcontractor's invoices that the contractor paid. The Purchasing Director kept the cash for his personal use.

Internal Control Weaknesses with Potential Indicators

- The subcontractor's 60-percent participation in the contractor's incurred cost is a potential fraud indicator due to the significance of cost incurred.
- The Purchasing Director did not adhere to the contractor's purchasing policies and practices. Also, the Purchasing Director involved the subcontractor in the fraudulent activity by pocketing the 20-discount paid to the company.
- The Chief Financial Officer endorsed the modification of the company's purchasing policy by approving the purchase order modification process and communicating acceptance to the Accounts Payable Director.
- The Accounts Payable Director did not adhere to the policies and practices for processing the subcontractor's invoice for payment. The process required that the subcontractor's invoices comply with a written subcontract agreement.
- A single contracting official (Director Purchasing) negotiating with the subcontractor is an internal control weakness and a potential fraud indicator. The contracting officials might have known of the 20-percent discount offered by the subcontractor if more than one contracting official attended the negotiations with the subcontractor.
- The contractor's lack of an independent monitoring process for its employees' compliance with policies and procedures is an internal control weakness. As a result, the contractor's system of checks and balances, designed to protect its assets and detect potential fraud, failed.

General Comments/Lessons Learned. Companies with employees performing in a war zone or similar environment such as developing nations have increased risk that assigned employees will not follow company policies and procedures. This scenario illustrates the importance of companies performing independent monitoring of employee compliance with company policies and procedures regardless of where they perform the work. In this scenario, the Accounts Payable Director failed to process the subcontractor's invoices in accordance with the policies, which required a review of the written subcontract agreement.

In addition, the Chief Financial Officer facilitated the breakdown in internal controls by modifying the purchase order to match the subcontractor's invoiced amounts. The Chief Financial Officer set the tone for the Accounts Payable Director to circumvent the internal controls in place to ensure the proper use of Federal funds and protect the contractor's assets. Early detection could have occurred had the contracting officials allowed the internal controls to function as intended. Additionally, the Purchasing Director openly expressing the desire to live a more lavish lifestyle is a potential fraud indicator. Therefore, this desire might have given the Purchasing Director the motivation to engage in the fraudulent activity. The deployment gave the Purchasing Director the opportunity he needed to steal government funds in order to live the desired lifestyle. In this scenario, the auditors were instrumental in stopping the misuse of Government funds and assisting in the return of the funds to the Government. The auditors recognized the fraud indicator of circumventing internal controls and referred the matter for investigation. However, including transactions initiated in the war zone in the auditors policy compliance audits might have aided them in identifying potential fraud indicators earlier.