

Subcontractor/Vendor Kickbacks

The Scenario

Risk Assessment-Research and Planning:

The auditor was assigned an incurred cost audit at XYZ, a non-major contractor with a mix of commercial and Government fixed-price and cost-type prime contracts and subcontracts. The contractor submitted the incurred cost submission for the previous year's costs several months prior, and an auditor determined that the submission was adequate for audit. The auditor reviewed general risk assessment information about the contractor, including the permanent file, previous incurred cost audits, the internal control questionnaire (ICQ), and the post-award accounting system audit. The auditor documented that prior auditors only questioned minimal costs in previous incurred costs audits and that the accounting system was considered adequate for the incurred cost year under review.

Because the internal control questionnaire in the permanent file was not current, the auditor submitted a written request to the contractor's representative to obtain an updated internal control questionnaire for the year under audit. The auditor also took the opportunity to schedule an entrance conference.

Preliminary Analytical Procedures:

The auditor performed the analytical mandatory annual audit requirement (MAARs) procedures in the standard audit program, including indirect cost comparisons with the prior year's actual costs and the budget for the year under review. The auditor identified sizable increases from both the budget and prior year historical costs in several unallowable overhead accounts. The auditor also noted that voluntary deletions in the submission were much larger than in the previous years' submissions and the costs charged to the business meals overhead account increased significantly.

Entrance Conference:

The auditor obtained a walk-through of the incurred cost submission from the contractor's representative to gain an understanding of the basis for the submission and the available supporting documentation. The auditor also asked the contractor the following series of questions regarding the submission and the updated internal control questionnaire provided by the contractor's representative to identify potential fraud risks.

Auditor Question: "Why did charges to the unallowable overhead accounts increase nearly 150 percent from the prior year's actual costs?"

Contractor Response: "I guess we just incurred more of these costs this past year. However, I'm not sure why you are concerned about our unallowable accounts since they were all voluntarily deleted from the claimed costs."

Auditor Question: "What changes have been made in the process for screening for unallowable costs?"

Contractor Response: "None that I am aware of. Our policy is still to review our costs for allowability when incurred. Same people doing the same thing."

Auditor Question: "Why did the costs charged to the overhead account for business meals increase 60 percent from the prior year's actual costs and 75 percent from the budget for this incurred cost year?"

Contractor Response: "I cannot specifically explain why these account expenses were much higher than before. Perhaps we just needed to do more business-related travel or events in indirect support to our contracts. We had a very good year and increased our sales substantially so it seems reasonable to me that these types of expenses would have increased as well."

Auditor Question: "Speaking of sales, we noted that sales increased about 75 percent over the prior year's sales. The increase appears to be mostly Government-related subcontract awards. However, the prime contractors for these awards are not identified in the submission. Please provide us a listing identifying the prime contractors for each newly awarded subcontract."

Contractor Response: "I would be happy to provide that listing but all subcontract awards were made by A+ Prime Contractor. We have established a very active business relationship with A+ based on mutual synergies and complementary services and products."

Auditor Follow-up Question: "How were these awards made?"

Contractor Response: "I will confirm, but I am pretty sure these were sole-source awards based on our newly formed teaming arrangement with A+ Prime Contractor."

Auditor Question: "What areas of XYZ's business has management identified as being high risk for potential fraud?"

Contractor Response: "We are a small company. All employees are like family. We do not believe that any employee is capable of or would commit any type of fraud against the company."

Auditor Follow-up Question: "Please describe XYZ's business ethics program and related policies and procedures."

Contractor Response: "We have business ethics policies and we provide annual ethics training to all our employees. Also our employees all know they can contact our legal counsel if they have any ethical questions or concerns."

Audit Team Brainstorming for Fraud Risk Assessment:

The auditor and supervisor discussed the results of the risk assessment/preliminary audit procedures and brainstormed about the various risks of fraud related to the audit. The only indicator identified and discussed was the increase in sole-source subcontracts from the same prime contractor.

The audit team concluded that the procedures in the standard audit program were generally sufficient to address the risk of unallowable costs in the submission. However, to address the risk of fraud, the audit team decided to include the following audit steps in the audit plan:

- Review the transactions comprising the voluntarily deleted (for example, unallowable entertainment, travel, employee morale, business conferences, etc.) costs in the submission to ascertain the types of costs incurred and not claimed for reimbursement.

- Review the business meals overhead account by performing a statistical sample of the account transactions with a sufficient sample size to address a high risk of significant misstatements in the account (high expected error rate), which the auditor is unwilling to accept (low tolerable misstatement). Trace the items selected for review back to source documents to determine the allowability, allocability, and reasonableness of the costs.

Results from Audit Procedures:

The auditor performed the planned transaction testing and identified the following issues during that testing:

- Most of the voluntarily deleted transactions were charged to the unallowable travel, unallowable conferences, and unallowable business meals accounts. These transactions included non business-related items such as resort vacation packages, tickets to various sporting events, concert tickets, and carpeting for personal residences.
- More than 50 percent of the transactions reviewed in the business meals overhead account were not properly documented. The supporting documentation had the names of the individuals who were present, but the reason for the meeting/meal was not recorded, as required.

Expanded Audit Procedures and Results:

The auditor and supervisor discussed the results of the testing and decided to expand testing of the business meals account. In addition, they discussed that the contractor could have charged other questionable payment transactions in related accounts such as travel and conferences. They decided to perform the following additional procedures.

- The auditor selected and reviewed additional transactions under an expanded statistical sample for the business meals overhead account and found several more transactions lacking documentation of the business purpose. However, as in the initial testing, the names of the participants were listed, and the auditor noticed that the individuals listed were the same as those found in the initial testing. Overall, approximately 50 percent of the charges reviewed from both the initial and expanded testing were not properly documented.
- The auditor developed a worksheet of the business meal account transaction detail (employee, dates, venues, locations, participants, etc.) to review for any patterns. This enabled the auditor to determine that the same company employees paid for the same individuals' lunches and dinners on a routine basis.
- To address the risk of more questionable transactions in other related accounts, the auditor reviewed the travel account and conference account details and noted that several airline and hotel expense transactions corresponded to the same locations as those of the questionable business meals/meetings. Many expenses were to or in resort locations. The auditor's review of the travel vouchers noted a pattern that the employees who submitted these travel

vouchers were the same employees who submitted the expense vouchers for the questionable business meals/meetings.

- The auditor compared the listing of individuals associated with the questionable business meals/meetings to those individuals associated with the voluntarily deleted non business-related purchases identified in the review and noted that the lists contained many of the same names.
- Recognizing that the transactions identified in the various accounts were an indicator of inappropriate kickbacks or bribery payments, the auditor compared the subcontract award dates from A+ Prime Contractor with the dates of the questionable transactions. This comparison revealed a pattern that purchase dates were typically within a month after award of a subcontract.

Additional Follow-up Actions:

- During discussions between the auditor and the contractor's representative on the identified deficiencies in the documentation, the contractor's representative stated that the individuals involved worked for A+ Prime Contractor and the expenses were likely various business meetings to discuss the new subcontract effort.
- The auditor also discussed with the contractor's representative that there did not appear to be any directly related costs (such as labor, travel, etc.) associated with the voluntarily deleted payment costs. The auditor requested the contractor's representative provide a written response either identifying any directly related costs that were not deleted from the submission or stating that there were none.
- The auditor contacted the audit office responsible for auditing A+ Prime Contractor to discuss the results of the audit and the pattern of irregular transactions between XYZ and A+ Prime Contractor. The supervisory auditor responsible for auditing A+ Prime Contractor said that they had recently issued a purchasing system deficiency report on this contractor's system. The cited deficiencies included failure to (1) maintain justification documentation for sole-source awards and (2) perform adequate cost/price analysis for its subcontracts. The supervisor also offered to look through the permanent files and use the online system access to try to identify where the A+ Prime Contractor individuals involved with the questionable transactions worked within the company. Several days after this discussion, the supervisor e-mailed the auditor that the individuals in question were mostly subcontract administrators in the procurement department with the remainder being program management personnel. The supervisor also attached a copy of the purchasing system deficiency report.

Further Actions:

The auditor and supervisor concluded that a written fraud referral, Defense Contract Audit Agency (DCAA) Form 2000, should be submitted immediately before completing the incurred cost audit. The auditor decided to have an informal discussion regarding the audit findings and referral with the DCAA investigative support auditor. The investigative support auditor suggested that certain information and documentation be included in the fraud referral.

Additionally, given the potentially illegal nature of the payment transactions, the investigative support auditor stated that contractor management may know about the activities and might have already submitted a contractor disclosure to the DoD Office of Inspector General ([The DoD Contractor Disclosure Program](#)). The investigative support auditor advised the auditor to check the permanent files to see whether their office had received a contractor disclosure for this matter but also offered to check a listing of disclosures for both XYZ contractor and A+ Prime Contractor. Shortly thereafter, the investigative support auditor sent a follow-up e-mail confirming that neither contractor had submitted a disclosure.

The auditor then set up a teleconference for their audit office, the audit office cognizant of the A+ Prime Contractor, the local DoD criminal investigator, the investigative support auditor, and the DCAA Justice Liaison Auditor to discuss the pattern of irregularities identified in the audit and the forthcoming fraud referral.

The auditor and supervisor also had a meeting with the Administrative Contracting Officer (ACO) and the Defense Contract Management Agency (DCMA) procurement fraud attorney to discuss the audit findings to date and the impact on the reliability of the contractor's business systems. The supervisor explained that a follow-up review of the contractor's business ethics program for compliance with the Federal Acquisition Regulation (FAR) and Defense Federal Acquisition Regulation Supplement (DFARS) requirements would be initiated as soon as possible.

General Comments/Lessons Learned:

The Anti-Kickback Act defines kickbacks as any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind that is provided directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract. However, detection of vendor kickbacks in the course of routine contract auditing is difficult. Standard audit procedures normally will not uncover such schemes.

The auditor must be alert to obvious weaknesses in the contractor's internal controls that make taking payoffs or accepting inappropriate gifts easy. When these indicators are identified, the auditor should be proactive and consider the following:

- contacting DCMA and recommending they initiate audits of the prime contractor's material purchasing, receiving, and storing systems to identify other weaknesses or noncompliance with existing contractor policies and procedures,
- performing physical verification of the existence of inventories or materials charged directly to a job to identify how vulnerable the contractor's system is to fraud, and
- performing a subcontract management review to evaluate the prime contractor's policies and procedures for awarding orders to vendors to ensure that proper procedures are followed.

Auditors should still refer potential inappropriate payments even when they have been recorded as unallowable or voluntarily deleted from the submission. The very act of making the payments constitutes a potential criminal violation of the Anti-Kickback Act whether the questionable payments are actually charged to Government contracts.

FRAUD INDICATORS

- **None or few contractor policies on ethical business practices including lack of anti-kickback training required for both employees and subcontractor employees.**
- **Poor enforcement of existing contractor policies on conflicts of interest or acceptance of gratuities.**
- **Poor contractor internal controls over key functional areas, such as purchasing, receiving, and storing.**
- **Lack of separation of duties between purchasing and receiving.**
- **Lack of separation of duties in the purchasing department. Buyers should be rotated to prevent familiarity with specific vendors.**
- **Indications of poor or no established contractor procedures for competition of subcontracts such as:**
 - **lack of competitive awards;**
 - **poor documentation supporting award of subcontracts, particularly sole-source awards;**
 - **lack of or inadequate cost/price analysis for subcontract awards; and**
 - **non award of subcontract to lowest bidder.**
- **Instances of buyers or other employees circumventing established contractor procedures for competition of subcontracts.**
- **Purchasing employees maintaining a standard of living obviously exceeding their income.**
- **A one-time payment for services or materials usually bought from another vender(s). The kickback recipient could be using the company to obtain his payoff.**
- **Supporting documents for transactions that indicate potential payments of commissions, entertainment, travel, expensive gifts or un-repaid loans to prime contractor personnel or government officials.**
- **Indications of patterns or relationship between potential irregular payment transactions and contracting/subcontracting actions such as awards, change orders, modifications, or other favorable contracting actions.**
- **Equipment charged to contract that cannot be located.**
- **Services charged to contract that cannot be substantiated as performed.**