

Supplier and outsourcing fraud

Whenever an organisation acquires goods or services from another party, or looks to outsource an internal function to an external organisation, there is a risk of fraud, which potentially could result in significant losses and reputational damage.

Introduction

There are numerous examples of organisations suffering significant financial losses from supplier fraud and reputational damage from the corrupt activities of outsourcing companies. The risk of fraud in the procurement lifecycle arises not only from suppliers and outsourcing companies, but also from within the organisation from employees and directors.

It is important that organisations are aware of the risks of fraud (and also corruption) to their internal processes for buying goods and services or outsourcing internal functions (such as call centres, payroll or accounting).

Commercial organisations also need to be mindful of their obligations under the Bribery Act 2010 to prevent bribery by persons working for or on its behalf (see our separate factsheet on *Bribery and Corruption* for more information).

The procurement lifecycle

Organisations should put in place internal controls and procedures to mitigate the risks of fraud that it identifies throughout the procurement lifecycle. The procurement process can be simplified as follows:

- identify business requirements for sourcing;
- identify potential suppliers and invite tenders;
- evaluate suppliers, proposals and tenders;
- negotiate terms and award contract;
- receive goods and/or provision of services;
- make payment and complete general ledger accounting;
- periodically re-evaluate suppliers.

Potential fraud risks

Employees may:

- set up dummy suppliers and/or submit false invoices for payment for their personal benefit;
- change the payment details of legitimate suppliers temporarily to divert payments for their personal benefit;
- favour suppliers in which they have an interest (eg, a family member's business);
- manipulate supplier records through false accounting;
- order goods or services from suppliers for their personal benefit and then arrange for the organisation to pay for them;
- accept overcharging on invoices against short delivery of goods or materials for personal gain;
- breach laws and regulations such as the Bribery Act 2010.

Suppliers may:

- submit phantom bids from dummy companies to give the appearance of proper competition;
- dishonestly disclose or fail to disclose accurate pricing on contracts;
- dishonestly charge at a price not contractually agreed and/or charge for work not done or services not delivered;

- provide goods and services that are poor quality, defective or not as specified;
- intentionally submit below-the-market rates in order to win a tender and then either increase the price or apply above-the-market rates on future sales;
- hide their corporate structure so that the tendering process will not identify bids from the same parent company;
- breach laws and regulations such as the Bribery Act 2010.

Employees may collude with suppliers to:

- specify or frame the organisation's requirements in such a way as to unfairly favour the supplier;
- provide information to give one supplier an advantage over other suppliers who are tendering for the same contracts;
- inflate prices over and above the market rate for goods and services;
- alter submitted bids to prejudice other suppliers or advantage a corrupt supplier;
- receive kickbacks or bribes from suppliers for the award of contracts.

Suppliers may collude with each other to:

- rotate the awarding of contracts in a syndicate of corrupt suppliers by artificially inflating prices, making it appear that one supplier's pricing is competitive;
- refrain from submitting tenders for the same contract or withdraw a previously submitted bid to favour one supplier;
- submit token bids that are clearly priced too high or have unacceptable terms and conditions to favour the supplier offering a lower bid.

This list is not exhaustive.

Additional outsourcing risks

When outsourcing internal functions to third parties, organisations have to rely on the outsourcing provider's internal controls and procedures to prevent fraud. Therefore it is critical when choosing an appropriate

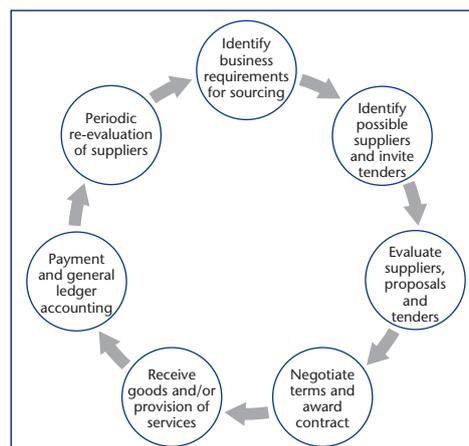


Figure 1: the procurement process

outsourcing provider to not only consider operational factors in the decision-making process, but also the increased risk of fraud.

For example, an organisation appoints an outsourced payroll provider without conducting any enquiries about the internal procedures it has in place to prevent ghost employees being added to the payroll. Instead the organisation simply assumes that the provider has adequate controls in place. The provider does not, and a rogue employee adds ghost employees that are then paid.

Outsourcing providers may be based overseas and/or have a completely different culture and approach to fraud risk management. Significant attention should be paid to these differences before a contract is agreed, and a thorough due diligence exercise should be conducted to identify and mitigate any potential risks arising from these.

Warning signs

Detecting fraud throughout the procurement lifecycle can be difficult, especially where there is collusion by employees and suppliers. In some instances a fraud may go undetected for extended lengths of time before any red flags or warning signs are identified.

Some warning signs include (but are not limited to):

- inappropriate levels of communication between an employee and a supplier prior to and during the tender phase of a contract;
- a supplier who fails to win a tender is employed by the winning supplier as a subcontractor;
- changes are made to the tender process without clear commercial or operational reasons;
- suitable suppliers decline to bid for a tender;
- a supplier fails to correct previously identified errors in pricing or reports;
- a high proportion of goods or services do not meet quality requirements;

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- missing documents or omissions in reports provided by a supplier;
- employees who are overprotective of specific suppliers;
- employees who override the organisation's internal controls and procedures;
- sudden unexplained changes in the lifestyle of employees responsible for procurement;
- sudden unexplained changes in employees' and suppliers' behaviour;
- significant returns to particular suppliers;
- unusual suspense accounts or requests for payment.

How to protect your business

DO:

- ✓ Identify and consider the risks of fraud applicable to each stage of the procurement lifecycle.
- ✓ Review existing internal controls and procedures to mitigate the risks of fraud and implement or improve procedures as required.
- ✓ Segregate the duties and functions of employees at each stage of the procurement lifecycle; consider periodic rotation of procurement purchasers.
- ✓ Make all staff (including contractors) aware of your organisation's policies on fraud, bribery and corruption, hospitality and the acceptance of gifts.
- ✓ Make all suppliers and outsourcers aware of your organisation's policies and procedures on fraud. Consider including compliance with these in your terms of business and/or contracts as appropriate.
- ✓ Establish a credible mechanism for staff to report suspicions of fraud. Encourage an open culture where the reporting of genuine suspicions is acceptable.
- ✓ Conduct due diligence on all suppliers and third parties. Check sanction and excluded party lists where appropriate.

- ✓ Evaluate the anti-fraud, bribery and corruption policies of all major suppliers and outsourcers (particularly new ones) to ensure that they are compatible with your own.
- ✓ Include a right to audit and/or inspect clause in contracts with suppliers and outsourcing providers. Exercise that right on a regular basis.
- ✓ Request disclosure of interests by all parties involved. Independently conduct conflict of interest checks.
- ✓ Monitor and review supplier and outsourcing provider performance.
- ✓ Put contracts up for re-tender after an appropriate time period. Keep unsuccessful tender documents and periodically review them to identify patterns.

DO NOT:

- ✗ Ignore employee and supplier complaints.
- ✗ Accept deficiencies in performance, pricing and quality.
- ✗ Accept variations to contractual terms without proper justification and internal approval.
- ✗ Accept suppliers and employees at their word alone.
- ✗ Ignore changes in supplier and employee behaviour or lifestyle.

Further information

See our separate fraud facts on *Fraud Risk Management*, *Anti-Fraud Policy Statements* and *Bribery and Corruption* for more information.

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