



FORENSIC, FRAUD AND INTERNAL CONTROLS WORKSHOP

Theme: Uncovering Fraud from the shadows

Date: 28th to 29th November 2019

Venue: Hilton Hotel, Nairobi Kenya

Presented by: Alex Musungu, MCIPS, MKISM

Why is procurement a wet area in terms of fraud



Uncovering Fraud from the shadows



- ❑ The biggest competitor you didn't know you had: fighting fraud has moved front and centre to become a core business issue
- ❑ A perfect storm of risks: In this era of unparalleled public scrutiny, today's organizations face a perfect storm of fraud related risks – internal, external, regulatory and reputational
- ❑ The fraud you don't see is as important as the fraud you do: very few companies are fully aware of the individual risks they face

Why is procurement a wet area in terms of fraud



- ❑ Procurement generally involves making buying **decisions** under conditions of **scarcity**

The Procurement Process

The Essential Phases



Procurement

- ✓ Procurement refers to those processes, procedures and entities involved in the purchase of goods and services by public and private entities
 - ❑ Identify Need
 - ❑ Establish Specifications
 - ❑ Solicit & Evaluate Bids & Proposals
 - ❑ Draft & Negotiate & Award Contract
 - ❑ Monitor Performance

What is fraud



- ❑ “Any illegal act characterized by *deceit, concealment*, or *violation of trust*
- ❑ These acts are not dependent upon the threat of violence or physical force
- ❑ Frauds are perpetrated by parties and organizations to obtain *money, property*, or *services*; to avoid payment or loss of services; or to secure personal or business advantage”

Institute of Internal Auditors

What is procurement fraud



- ❑ Procurement fraud is a deliberate deception intended to influence any stage of the procure-to-pay lifecycle in order to make a financial gain or cause a loss.
- ❑ It can be perpetrated by contractors or sub-contractors external to the organization, as well as staff within the organization
- ❑ It is a **kickback** to the buyer from the supplier for selecting the suppliers bid and which might not be in the best interest of the company.

Types of procurement fraud



- ☐ Kickbacks
- ☐ Collusion among bidders to reduce competition
- ☐ Providing bidders with advance "inside" information
- ☐ Submission of false or inflated invoices for services and products that are not delivered or work that is never done. "Shadow vendors", shell companies that are set up and used for billing, may be used in such schemes

Types of procurement fraud



- ❑ Intentional substitution of substandard materials without the customer's agreement
- ❑ Use of "sole source" contracts without proper justification
- ❑ Use of prequalification standards in specifications to unnecessarily exclude otherwise qualified contractors
- ❑ Dividing requirements to qualify for small-purchase procedures to avoid scrutiny for contract review procedures of larger purchases

Procurement fraud – Red Flags



- ☐ Unusual/unauthorized vendors
- ☐ Large gifts and entertainment expenses
- ☐ Unusual increase in vendor spending
- ☐ Exact bid amounts (i.e. Kshs 500,000)
- ☐ Duplicate payments – *Certified Invoices*
- ☐ Sequential invoices paid
- ☐ Payments just under authorization level
- ☐ Employee-vendor address match
- ☐ Multiple invoices paid on same date
- ☐ Slight variation of vendor names

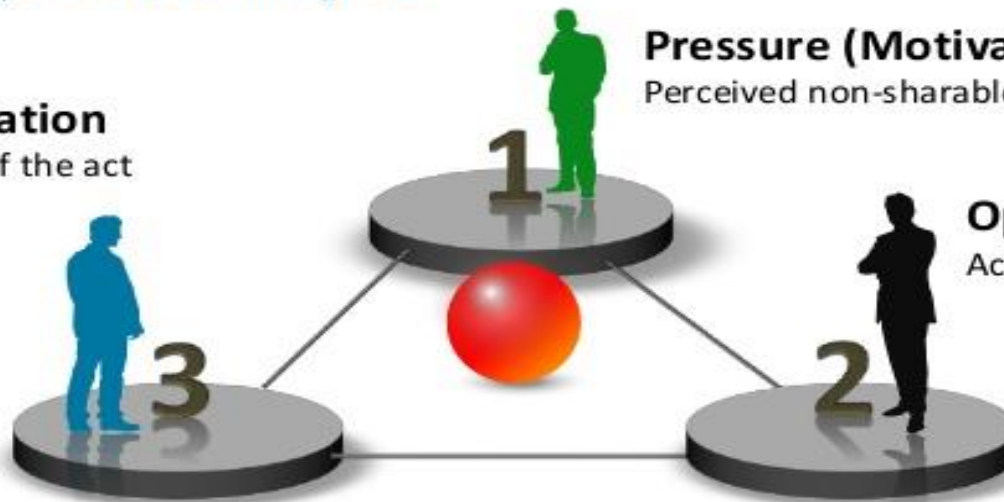
Procurement fraud – Red Flags



The Fraud Triangle

The Fraud Triangle is model for explaining the factors that cause someone to commit occupational fraud. It consists of three components which according to Donald Cressey must be present at the same time for an ordinary person to commit fraud

Rationalization
Justification of the act



Pressure (Motivation)
Perceived non-sharable financial need

Opportunity
Access to resources

Fraud schemes pre, during and post procurement



✓ Fraud in the pre-contract award phase

- ❑ The pre-contract award phase generally involves the core stages of pre-tendering– defining the requirement, developing the specification, producing a business case and tendering – market engagement, bidder selection and bidder evaluation.
- ❑ This phase ends in the award of a contract
- ❑ Fraud during this phase can be complex and difficult to detect
- ❑ Much of the fraud occurs in an organization's external environment, either with or without the knowledge of those involved in the procurement process.

Fraud schemes pre, during and post procurement



✓ Fraud in the procurement phase

- ❑ Short notice period of tendering process
- ❑ Advertise in www that are “TIMED OUT”
- ❑ Bids tailored to meet specifications of a particular supplier
- ❑ Unreasonably narrow or broad specification
- ❑ No clear bid submission information
- ❑ Specification done together with supplier

Fraud schemes pre, during and post procurement



✓ Fraud in the post-contract award phase

- ❑ It focuses firmly on contract management, specifically on payments made on contracts
- ❑ Most public bodies use an electronic accounts payable system, with key controls around separation of duties between requisition, ordering, checking and inspecting receipt of goods and services and authorizing payment
- ❑ Notable examples involves overpayments to suppliers through the fraudulent submission of duplicate or false invoices which had been unknowingly paid by finance teams

Frauds relating to contracting and contract management



✓ Contracting

- ❑ Having moved through the supplier selection phase, the next critical point at which fraud can take place is during the contract negotiations and in agreeing the detailed terms and conditions:
 - a) **Terms and conditions** - this requires collaboration between an insider and the supplying firm.
 - b) **Fraudulent Offsets, Local Content Claims** - whilst fraud can start here once the contract is up and running, the seeds are often sown at the contracting stage.

Frauds relating to contracting and contract management



✓ Contract management

- ❑ In the phase which involves suppliers actually delivering the work, whether that is goods, services or works, there are a vast number of potential frauds that can be executed:
 - **Quality of goods (or services)** - the supplier delivers something that is of lower quality than it is contracted to provide e.g Horse meat for burgers
 - **Fake invoices** - Basically, invoices are submitted when nothing has actually been delivered to the buying organization
 - **Volume over-invoicing** - in these cases, the supplier does actually provide some goods or services, but invoices for more than what has actually been delivered

Frauds relating to contracting and contract management



- ✓ **Contract management**
- **Price-related over-invoicing** - the price invoiced is greater than what is contractually agreed or allowable
- **Invoice diversion** - is whereby a legitimate payment that should go to a certain supplier is diverted to a third party fraudulently
- **Easing contract terms** - collaboration between buyer and seller allows the supplier to benefit from a change in contract terms that benefits them
- **Stealing products** - start selling online

Role of internal audit in preventing and detecting procurement fraud



- ❑ Internal Audit (IA) is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

Role of internal audit in preventing and detecting procurement fraud



- ❑ IA is responsible to assess the effectiveness of **risk management, control and governance processes** and to provide insight and recommendations that can enhance these processes, particularly relating to:
 - a) Effectiveness of operations
 - b) Reliability of financial management and reporting
 - c) Compliance with laws and regulations

Role of internal audit in preventing and detecting procurement fraud



- ❑ IA may also involve conducting fraud investigations to identify fraudulent acts and conducting post investigation fraud audits to identify control breakdowns and establish financial loss

Role of internal audit in preventing and detecting procurement fraud



- ✓ Operationally, internal audit should have sufficient knowledge of fraud to:
 - Identify **red flags** indicating fraud may have been committed
 - Understand the characteristics of fraud and the techniques used to commit fraud, and the various fraud schemes and scenarios
 - Evaluate the indicators of fraud and decide whether further action is necessary or whether an investigation should be recommended
 - Evaluate the effectiveness of controls to prevent or detect fraud

Role of internal audit in preventing and detecting procurement fraud



✓ *Some recommendations*

- ☐ Enhance public education and sensitization on individual role in the fight against corruption and unethical conduct;
- ☐ Enhance corruption and unethical conduct reporting channels;
- ☐ Strengthen leadership, integrity and anti-corruption laws to allow for quick handling of cases and harsher punishment for persons found guilty; and
- ☐ Companies and their directors engaged in corruption and unethical conduct should be blacklisted and or deregistered
- ☐ Carry out Procurement Fraud Training – for forensic auditors and Procurement
- ☐ Data analytics should be deployed to detect anomalous behaviour – links between employees and criminals

Role of internal audit in preventing and detecting procurement fraud



- ❑ Introduce an award and reward system for anti-corruption champions – **5% of proceeds as suggested by Building Bridges Initiative (BBI)**
- ❑ The **procurement** should conduct affairs **devoid** of **political** and **executive** interferences
- ❑ The laws should be put in place to enhance asset recovery and restitution mandate
- ❑ Public and State Officers should be audited annually to establish their net worth hence enhancing accountability
- ❑ Enhance policies and laws to govern the protection of whistle-blowers

Third-Party Relationships and the Associated Frauds.



✓ Every organization should be aware of and actively manage some of the most common third-party contract risks:

- ❑ **Reputation**—Third-party contractor damages the reputation of the organization through their actions, or lack thereof.
- ❑ **Performance**—Third-party contractor fails to meet timelines and/or fails to perform in accordance with terms of the contract.
- ❑ **Compliance**—Third-party contractor fails to comply with laws and regulations governing the performance of the contract.

Third-Party Relationships and the Associated Frauds.



- ❑ **Non-Conforming Goods**—Third-party contractor delivers goods or services not conforming to contract specifications
- ❑ **Change Order Abuse**—Third-party contractor increases the price or extends and expands the contract scope through the use of multiple change orders
- ❑ **Cost Mischarging**—Third-party contractor charges the organization for costs (material or labour) not allowable, reasonable or allocable to the contract
- ❑ **Data Breaches**—Third-party contractor, either intentionally or through the ineffectiveness of its information technology security and controls, mismanages critical organization or customer data

Third-Party Relationships and the Associated Frauds.



✓ How to manage the risks

- ❑ The harsh reality is many organizations do not have the necessary processes or safeguards in place to address key third-party contract risks
- ❑ It is critical to take the following actions to protect your organization:
 - **Include a “right to audit” clause** – Make sure every contract signed has a “right to audit” clause included in the terms and conditions
 - **Educate and empower employees** – Employees who play a role in your third-party contract relationships should be educated on the critical terms and conditions of each contract and empowered to ask questions

Third-Party Relationships and the Associated Frauds.



- **Review internal controls** – Ensure your internal checks and balances have been designed and are operating effectively to protect your organization from errors or potential wrongdoing by outside third-parties
- Some key controls include making sure there is a formal process with **proper segregation of duties** for reviewing and approving:
 - Contracts
 - Change orders
 - Invoices/payment applications
 - Receipt/acceptance of goods and services

Third-Party Relationships and the Associated Frauds.



- **Assign a contract monitor** – An employee or employees (depending on number of contracts) should be assigned the role of contract monitor

Conclusion



Be prepared. Face the fraud.
Emergence stronger.

End



Q & A

Case Study 1



- Hitos Enterprise is one of the leading manufacturers of FMCG in Kenya. Recently the company's Head of Internal Audit and Risk noted a negative trend in stock variances in two key raw materials used by the company. Prepare a board paper to the Audit and Risk Committee of the Board of Directors detailing various types of procurement fraud likely to occur at the supplier selection stage that are supplier-driven, staff-driven and conspiracy

Case Study 2



- Dada Smart (DS) is a newly registered Sacco operating in Lamu County with a current membership of 15,000 women. The Sacco has no financial capability to invest in an *e-commerce technology* for its operations in the next two years. As a seasoned Forensic Auditor from Lamu County you have noted that it is not impossible to implement a purely manual system including the same processes, but it is much easier where the transactional process has been standardised and systemized. Discuss some of the key steps that DS should consider to enable her achieve her mandate.

Case Study 3



- Hope Regulatory Authority (HRA) is a state agency responsible for Kenya's strategic maize reserve. The Kenyan Parliament recently authorized HRA to import 300,000 tonnes of maize to alleviate imminent hunger following poor harvest by the main farmers who supply it. CPA Jordan is one of the forensic auditors retained by HRA for purposes of providing advise to the Board of Directors and Management of HRA.

In one of the management meetings, CPA Jordan in his usual presentations you heard him state as follows:

“Vigilance against procurement fraud is crucial for ensuring HRA gets the right results from its procurement. It's also essential to preserving stakeholder trust, company reputation and preventing unnecessary overspend.

Procurement fraud can be difficult detect as well as complex to investigate.”

You are required to compile a list of six common types of procurement fraud and their warning signs to address the sentiments made by CPA Jordan.