Procurement Fraud: Do you look good in stripes?

How to detect and prevent fraud

Presented by: Janet Hasty, CPPO, CTPM

Government Procurement Services
Janet Hasty, CPPO, CTPM

• State of Texas Procurement (1977-2007)

• Owner, Government Procurement Services (2007)

• Bachelor’s in Public Administration, St. Edwards University

• Master of Public Affairs, University of Texas, LBJ School of Public Affairs
Agenda

• Discuss procurement fraud and the results of an international survey on fraud.

• Review federal laws related to procurement fraud

• Examine the different types of procurement fraud, including real life examples.

• Analyze various fraud indicators
Procurement Fraud Definition

Dishonestly obtaining an advantage, avoiding an obligation or causing a loss to public property during the procurement process by public servants, contractors or any other person involved in the procurement.

Procurement Fraud

Do you want to hear a surprising statistic?

Executives and managers commit 53% of fraud that is committed in the workplace!

Source: Association of Certified Fraud Examiners (ACFE)
The Association of Certified Fraud Examiners publishes an annual report on occupational fraud and abuse.

The findings of the 2020 report are the results of 2,504 cases of occupational fraud investigated by Certified Fraud Examiners in 125 countries between January 2018 and September 2019.
Fraud Losses (U.S. & Canada)

Median Loss from Fraud

- Employees: $60,000
- Managers: $139,000
- Executives: $438,000
Fraud Perpetrators

Tenure of Perpetrator

- Less than 1 Year: 9.0%
- 1 to 5 Years: 46.0%
- 6 to 10 Years: 22.0%
- More than 10 Years: 23.0%
Fraud Perpetrator Profile

• Never been charged or convicted of a crime (89%)
• Male (72%) – Female (28%)
• Have a university or post graduate degree (64%)
• Committed by employees 31-45 years of age (53%)
• Committed by one individual (49%)
Poll:

How is Fraud Initially Detected? (U.S. & Canada)
How is Fraud Initially Detected? (U.S. & Canada)

Initial Detection

- Tips: 37%
- Manager Review: 15%
- Internal Audit: 14%
- Accident: 7%
- Acct. Reconcile: 4%
- External Audit: 4%
- Doc. Examination: 4%
- Monitoring: 3%

Note: Other methods in report not shown here.
Behavior Red Flags

Most perpetrators display at least one red flag:

- Living beyond their means (42%)
- Experiencing financial difficulties (26%)
- Unusually close association with vendors (19%)
- Control issues, unwillingness to share duties (15%)
Federal Laws

• Sherman Act (1890) – prohibits any agreement among competitors to fix prices, rig bids, or engage in other anti-competitive activity.

• Criminal enforcement is with the U.S. Department of Justice.

• Punishment:
  • Fines up to $100 million for corporations
  • $1 million or 10 years imprisonment (or both) for individuals
Sarbanes-Oxley Act

• Passed in 2002 in response to the collapse of Enron, WorldCom, and other corporations.

• Sets standards for publicly held boards, management, and public accounting firms.

• Protects shareholders and the general public from accounting errors and fraudulent practices.
False Claims Act

• Allows citizens with evidence of fraud to sue on behalf of the government to recover the stolen funds (1863).

• Persons filing under the Act can receive a portion (usually 15%-25%) of any recovered damages.

• In FY2019, the federal government recovered more than $3 billion from fraud and false claims. (U.S. Dept. of Justice)
Example of False Claims Act Payout

• In 2017, Comprehensive Health Services Inc. (CHSI) agreed to pay $3.8 million dollars under the False Claims Act.

• James Kerr, a former employee of CHSI received $645,391.

• From 2009-2014, CHSI knowingly double charged the IRS for medical services when those costs were already included in the bundled price for an applicant pre-placement exam.
Discouraging Fraud

• Expand the Bidders List
  • Past experience suggests that fraud is more likely when there are five or less competitors.

• Educate Purchasing & Contracting Professionals
  • Be familiar with the fraud indicators and what to do if you suspect fraud.
Discouraging Fraud

• Collect Bid Data
  • Use your purchasing systems to help to determine patterns of fraud, including bid allocation or rotation.

• Ask Questions of Bidders
  • If bid prices don’t make sense, ask vendors to explain.

• Administer Contracts
  • Use trained contract managers to administer contracts.
Discouraging Fraud

• Ensure separation of duties for the purchasing, receipt and payment functions.

• Know and understand the dynamics of the markets in which you make major purchases.

• Establish clear policies, procedures and documentation requirements for the procurement process.
Poll:

Does your office have up-to-date policies and procedures in place to discourage fraud?
Collusion

When two or more parties act together secretly to achieve a fraudulent or unlawful act. May manifest itself in the form of bid collusion when bidders secretly agree to unlawful practices regarding competitive bidding. May inhibit free and open competition in violation of antitrust laws.

*Source: NIGP Dictionary of Purchasing Terms*
Types of Procurement Fraud

1. Bribery and Kickbacks
2. Falsified Invoices
3. Change Order Abuse
4. Product Substitution
5. Price Fixing
6. Market Allocation
7. Bid Rigging
8. Manipulation of Bids
9. Unbalanced Bidding
10. Unjustified Sole Source Awards
1. Bribery & Kickbacks

• **Bribery** is receiving something of value to corruptly influence the actions of another, most commonly to influence a contract award.

• A **kickback** is a bribe paid by the vendor to the recipient.
2. Falsified Invoices

• Falsify data
• Inflate prices
• Duplicate invoices
“All the Queen’s Horses” Documentary

• Rita Crundwell, Comptroller for the City of Dixon, Illinois
  • Population of approximately 15,000
  • Boyhood home of Ronald Reagan

• Rita embezzled over $53 million dollars from this small city over a 20-year period!

• Fraud started in 1991 and lasted until her arrest in 2012

• Single largest municipal fraud in U.S. history
How Rita Did It

• She was the lone signatory for the City of Dixon bank accounts.
• She opened up a fake bank account in which she transferred money into from the various other city accounts.
• The money was transferred to pay fake invoices she created for capital improvements. Over the 20-year period, she submitted 170+ fake invoices.
• She used the money from the fake account to pay for her lavish lifestyle which included several horse ranches, over 400 thoroughbred horses, a $2 million dollar motor home, and much more.
• Most people thought she made her money through horse breeding.
How Rita Got Caught

• She was at a horse show and a city employee noticed a discrepancy in a financial statement. The city employee asked the bank for all of the bank account statements. This included the account that Rita used for her personal expenses!

• The employee turned over the statements to the Mayor, who in turn contacted the FBI.
The Aftermath

• Rita was sentenced to 20 years in prison.

• An auction of Rita’s possessions netted the city approximately $10 million dollars.

• The bank and the accounting firm paid over $40 million dollars back to the city for their negligence.
Ironically...

• Ronald Reagan is famous for the quote: “Trust, but verify”

• All those involved obviously trusted Rita too much, and never verified the information she provided.

• I encourage you to watch the documentary.
Red Flags for Falsified Invoices

• Weak or un-enforced controls in the receipt of goods/services.

• Inadequate, copied or altered supporting documents.

• Invoiced goods/services can’t be accounted for or located.

• Invoice prices, amounts, item descriptions or terms exceed or do not match the contract.
3. Change Order Abuse

• Vendors reduce bid price to win contract – then get inflated profits through excessive change orders.

• Most often occurs in construction contracts.
Change Order Abuse Example

• West Coast Construction contracted with the government to remodel an office building. Original bid price was $1.4 million. Change orders increased the cost to $1.9 million.

• Even though price was increased, the government found:
  • Change orders did not match price schedule for labor
  • Unauthorized overtime was claimed
  • Equipment rental rates exceeded rates allowed by the contract.
Red Flags for Change Order Abuse

- Weak controls and lax change order procedures.
- Numerous, unusual or unexplained change orders from a specific vendor approved by the same employee.
- Vague contract specifications followed by change orders.
- Pattern of low bid award – followed by change orders.
4. Product Substitution

Counterfeit or substandard products, such as using:
- “Watered down” loads of concrete
- Inferior computer memory chips
- Substandard auto parts
- One coat of paint when two coats is required
Product Substitution Example

• Alchemy Inc. made fire hose nozzles used by the Navy.

• Navy found that 70% of the nozzles failed tests as they were made from inferior materials.

• The president, Leo Schweitzer received a 15-year prison sentence.
5. Price Fixing

Agreement among competitors to raise, fix or otherwise maintain the price of their goods or services.
Examples of Price Fixing Agreements

- Hold prices firm/raise prices
- Eliminate or reduce discounts
- Adopt a standard formula for computing prices
- Adhere to a minimum fee or price schedule
Price Fixing Example - Bread

• A group of Canadian retailers and bread makers overcharged consumers by an estimated $5 billion dollars over 15 years (2001-2015) by artificially raising bread prices.

• It was considered an “industry-wide” scheme and even had a name (7/10 convention). A 7-cent price increase at wholesale and a 10-cent price increase to the retail consumer.

• There is a current $1 billion class action lawsuit on behalf of all Canadians who purchased bread from the named grocers from 2001 to 2019.
Chat Time!!!

We have covered 5 of the 10 types of procurement fraud. Let’s see if you have any questions about these before we move on to the last five.

1. Bribery and Kickbacks
2. Falsified Invoices
3. Change Order Abuse
4. Product Substitution
5. Price Fixing
6. Market Allocation

• Competitors divide markets among themselves.

• Allocate by customers, or types of customers, products or territories.

• **Indicator:** Competitors refuse to sell to customers outside of their territory.
7. Bid Rigging

An agreement among some or all of the bidders which predetermines the winning bidder and limits or eliminates competition among the conspiring vendors.

There are several types of bid rigging.
Bid Rigging Schemes

- Complementary Bidding
- Bid Suppression
- Bid Rotation
- Subcontracting
Complementary Bidding

- The most frequently used method of bid rigging.
- Designed to give the appearance of competitive bidding.
- Competitors agree to submit bids that are either too high or contain special terms so that their bids will not be accepted.
Bid Suppression

Bidder refrains from bidding so that the designated competitor’s bid wins.
Bid Rotation

• All conspirators submit bids - but take turns being the low bidder.

• May rotate based on:
  • Allocate equal amounts
  • Size of contract
  • Allocate amounts relevant to the size the conspirator’s company

• Easier method to catch if a rotation pattern is established.
Subcontracting

• Competitors agree not to bid, or to submit a losing bid. In exchange, they receive subcontracts or supply contracts from the awarded bidder.

• Sometimes, a low bidder withdraws their bid in favor of the next low bidder and both will split the price difference.
8. Manipulation of Bids

A procurement employee manipulates the bidding process in a way to benefit a favored vendor.
Red Flags of Bid Manipulation

• Winning bid voided for “errors in specifications” and the job is re-bid

• Bids are “lost” and then “found”

• Qualified bidders disqualified for questionable reasons.
9. Unbalanced Bidding

• Includes a number of schemes in which bidders manipulate line item bid prices in order to gain advantage in the bid process.

• Quoting high prices on line items that the vendor knows or anticipates will be the subject of change orders to increase the quantity.
Unbalanced Bidding Examples

- Vendor quotes a high price on 100 safety barriers – when the vendor knows the quantity will likely be increased to 300.

- Vendor quotes lower prices on items that they know (through tips from bribed officials) will not be called for during the contract. Submitting a lower price for unneeded items favors the vendor.
Red Flags of Unbalanced Bidding

• Particular line items appear to be unreasonably low.
• Particular line items are not used during the contract.
• Vendor is close to procurement personnel or participated in the contract specifications.
10. Unjustified Sole Source Awards

- Procurement official avoids or defeats competitive selection requirements by making an improper award to a favored vendor.

- Typically made by citing special circumstances.

- If corruptly motivated, such awards often result in higher prices and/or lower quality.
Red Flags for Unjustified Sole Source Awards

• Previously competitive procurements become non-competitive.

• No valid justification or documentation for sole source.

• Awards made below the competitive bid limits – followed by change orders that exceed the bid limits.
Chat Time!!!

Now we have covered all 10 types of procurement fraud. Any questions about the last five types we discussed?

6. Market Allocation
7. Bid Rigging
8. Manipulation of Bids
9. Unbalanced Bidding
10. Unjustified Sole Source Awards
What Should You Do?

• Go with your gut instincts or intuition, they are usually right.

• Recognize that rumors are sometimes true.

• Keep your eyes open and report any suspicious activity or problem that seems to become a pattern – no matter how small.
Indicators – Not Proof

• Indicators are just that, “indicators” of possible wrongdoing.

• There may be perfectly legitimate reasons for the indicators or suspicious behavior.

• Report them for further investigation.
In Closing

• The difference between a mistake and fraud is the intent! Most contracts are not tainted by fraud and most fraud indicators do not result in actual fraud.

• By looking for fraud indicators and properly reporting them, you are taking steps to uncover fraudulent acts, identify the fraudster, and protect government resources.
Questions?

THANK YOU!

Janet Hasty, CPPO, CTPM

Government Procurement Services

(888) 254-7715

janet@gpstraining.biz
Resources:

• Association of Certified Fraud Examiners; https://www.acfe.com/report-to-the-nations/2020/

• All the Queen’s Horses” Documentary, Amazon Movies or YouTube

• Attorney Devon Bruce discusses how Rita Crundwell’s case. “Embezzling $53 MILLION: How Rita Crundwell Operated the Largest Municipal Fraud in American History, YouTube