



# **OFFICE OF THE INSPECTOR GENERAL INVESTIGATIONS**

## **FRAUD INDICATORS**

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## **INTRODUCTION TO FRAUD INDICATORS**

Fraud indicators are best described as clues or hints that a closer look should be made at an area or activity. Generally there are two approaches that the person intent on committing fraud will consider, choosing one over the other depending on skill, experience, inclination and the level of internal controls. Activities may be either completely covert or hidden from view, or they may be conducted in the open, completely obvious to all, but disguised to appear as if they are part of the normal operations. When the former is detected, it may be much easier to determine what is actually going on, while the latter, if well done, may be much more difficult to decipher.

One more element is worth noting in regard to potential indicators of fraudulent activity. The manager, auditor, or investigator must know the industry, the system, or the field and must establish what are accepted practices. It is hard to spot an aberration when you don't know the norm. It is difficult, if not almost impossible, to detect a well designed fraud if you do not know what you are looking for. Bear in mind that a fraud indicator may or may not be significant, depending on what it is, what other indicators are present and the context of the organization's transactions.

Although poor management decisions or negligence may give rise to possible indications of fraud, the difference between fraud and negligence is a fine line called intent. All that fraud indicators can do is to point the way for further detailed inquiry.

Managers, auditors, and investigators can use the attached lists to assist in the monitoring of activities or the review of records.

## **FRAUD IN GOVERNMENT CONTRACTS**

The contract award process has been designed to efficiently ensure the delivery of goods and services. This section will discuss factors which may indicate the presence of or enhanced potential for fraud at various stages in the contract award process. The indicators included are not intended, each taken alone, to establish the existence of fraud. Rather, the presence of any of these indicators should cause employees to be alert to the possibility of impropriety and to take appropriate actions to ensure the integrity of the process.

The motives and methods for fraud in the contract award process are varied. Fraud may be perpetrated to obtain a contract in order to create the opportunity to later engage in such activities as theft or embezzlement, product substitution, cost mischarging, fast pay or progress payment fraud. In some instances, fraud may be perpetrated to obtain a contract at a higher price or with better terms than would have occurred in an award untainted by fraud. A company may attempt to obtain a contract through fraud because the business is needed to continue operations when private sector activity is low.

### Fraud in the Identification of the Need for Goods or Services

The potential for fraud is created when the need assessment is not adequately or accurately developed. A Government agency which, with or without collusion, continually changes its mind about what it wants, will make it possible for a contractor to substantially increase the contract price. With respect to fraud in defining requirements and stock levels, fraud indicators include:

1. Requiring excessively high stock levels and inventories in order to justify continuing purchasing activity from certain contractors.
2. Declaring items which are serviceable as excess or selling them as surplus while continuing to purchase similar items.
3. Purchasing items, services, or research projects in response to aggressive marketing efforts (and possible favors, bribes or gratuities) by contractors rather than in response to valid requirements.
4. Improperly defining needs in ways that can be met only by specific contractors.

5. Estimates are not prepared or are prepared after solicitations are requested.
6. Failing to develop "second-sources" for items, spare parts, and services being continually purchased from a single source.

#### Fraud in the Development of Statements of Work and Specifications

Bid specifications and statements of work are intended to provide both potential bidders and the selecting officials with a firm basis for making and accepting bids. A well written contract will have specifications, standards and statements of work which make it clear what the Government is entitled to. Sloppy or carelessly written specifications make it easy for a contractor to overcharge or for it to deliver less than expected.

Fraud indicators include:

1. Defining statements of work and specifications to fit the products or capabilities of a single contractor. Specifications are made so restrictive that they effectively exclude competing firms.
2. Advance or selective release by Government employees of information concerning requirements and pending purchases only to preferred contractors.
3. Using statements of work, specifications, or sole source justifications developed by or in consultation with a preferred contractor (institutional conflict of interest).
4. Allowing firms participating in project design to obtain those same contracts or to be subcontractors to the winning contractors.
5. Release of information by firms participating in project design to contractors competing for the prime contract.
6. Designing "pre-qualification" standards or specifications to exclude otherwise qualified contractors or their products.
7. Splitting up requirements so contractors each get a "fair share" and can rotate bids.
8. Splitting up requirements to get under small purchase requirements or to avoid prescribed levels of review or approval, e.g., to keep each within the contracting authority of a particular person or activity.

9. Bid specifications or the statement of work are not consistent with the items included in the general requirements.
10. Specifications that are so vague that reasonable comparisons of estimates would be difficult.
11. Specifications that are not consistent with past similar type procurements.
12. Specifications that do not include (specific) work site locations.

#### Fraud in Pre-Solicitation Phase

Fraud indicators include:

1. Unnecessary sole source justifications.
2. Falsified statements to justify sole source of negotiated procurement.
3. Justifications for sole source or negotiated procurement signed by officials without authority or the deliberate bypassing required levels of review.
4. Placing any restrictions in the solicitation documents, which would tend to restrict competition.
5. Providing any advance information to contractors or their representatives on a preferential basis by technical or contracting personnel.

#### Fraud in Solicitation Phase

Fraud indicators include:

1. Restricting procurements to exclude or hamper any qualified contractor.
2. Limiting the time for submission of bids so that only those with advance information have adequate time to prepare bids or proposals.
3. Revealing any information about procurement to one contractor, which is not revealed to all (from either technical or contracting personnel).

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4. Conducting bidders' conference in a way, which invites bid rigging or price fixing or permits improper communications between contractors.
5. Failure to assure that a sufficient number of potential competitors is aware of the solicitation.
6. The bid solicitation is vague as to the time, place, or other requirements for submitting acceptable bids.
7. Little or no control over the number and destination of bid packages sent to interested bidders.
8. Improper communication with contractors at trade or professional meetings or improper social contact with contractor representatives.
9. Government personnel or their families acquiring stock or a financial interest in a contractor or subcontractor.
10. Government personnel discussing possible employment with a contractor or subcontractor for themselves or a family member.
11. Special assistance to any contractor in preparing his bid or proposal.
12. "Referring" a contractor to a specific subcontractor, expert, or source of supply. (Express or imply that if you use the referred business you will be more likely to get the contract.)
13. Failure to amend solicitation to include necessary changes or clarifications. (Telling one contractor of changes that can be made after award.)

Fraud indicators include:

1. Improper acceptance of a late bid.
2. Falsification of documents or receipts to get a late bid accepted.
3. Change in a bid after other bidders' prices are known. This is sometimes done by mistakes deliberately "Planted" in a bid

4. Withdrawal of the low bidder who may become a subcontractor to the higher bidder who gets the contract.
5. Collusion or bid rigging between bidders.
6. Revealing one bidder's price to another.
7. False certifications by contractor.
  - a. Small business certification.
  - b. Minority business certification.
  - c. Information provided to other agencies to support special status.
  - d. Certification of independent price determination.
  - e. Manufacturer's certificate of warranty
8. Falsification of information concerning contractor qualifications, financial capability, facilities, ownership of equipment and supplies, qualifications of personnel and successful performance of previous jobs, etc.

#### Fraud in the Evaluation of Bids and Proposals

Fraud indicators include:

1. Deliberately discarding or "losing" the bid or proposal of an "outsider" who wants to participate. (May be part of a conspiracy between a Government official and a select contractor or group of contractors.)
2. Improperly disqualifying the bid or proposal of a contractor.
3. Accepting non-responsive bids from preferred contractors.
4. Seemingly unnecessary contacts with contractor personnel by persons other than the contracting officer during the solicitation, evaluation, and negotiation processes.
5. Any unauthorized release of information to a contractor or other person.
6. Any exercise of favoritism toward a particular contractor during the evaluation process.
7. Using biased evaluation criteria or using biased individuals on the evaluation panel.

8. Documents from competing firms contain similar or identical:

- a. Company names
- b. Handwriting/signatures
- c. Company stationery
- d. Invoice numbers (in sequence)
- e. Telephone numbers.

9. An odd company name for a vendor suggests that the firm may not provide the type of service or product being solicited.

#### Fraud in the Award of the Contract

Fraud indicators include:

1. Award of a contract to a contractor who is not the lowest responsible, responsive bidder.
2. Disqualification of any qualified bidder
3. Allowing a low bidder to withdraw without justification.
4. Failure to forfeit bid bonds when a contractor withdraws improperly.
5. Material changes in the contract shortly after award.
6. Advance information concerning who is going to win a major competition can give advantages to persons trading in the stock of both the winning and losing companies.
7. Awards made to contractors with an apparent history of poor performance.
8. Awards made to the lowest of a very few bidders without re-advertising considerations or without adequate publicity.
9. Awards made that include items other than those contained in bid specifications.
10. Awards made without adequate documentation of all pre-award and post-award actions including all understandings or oral agreements.

#### Fraud in the Negotiation of a Contract

Fraud indicators include:

1. "Back-dated" or after-the-fact justifications may appear in the contract file or may be signed by persons without the authority to approve noncompetitive procurement.
2. Information given to one contractor which is not given to others which give it a competitive advantage.
3. Improper release of information (e.g., prices in proposals, technical proposals or characteristics of proposals, identity or rank of competing proposals, proprietary data or trade secrets, and Government price estimates) to unauthorized persons.
4. Weakening the Government's negotiating position through disclosures to the contractor selected for award
5. Contractor misrepresentation as to costs during negotiations.
6. Failure of Government personnel to obtain and rely upon a Certificate of Current Cost or Pricing Data (if required).

#### Fraud in the Post-Award Phase

1. The receipt of goods and services is certified even though physical inspections have not been performed.
2. Contractors fail to meet the contract terms but nothing is done to force compliance. Follow up always needed.
3. Contractors are not required to return excess materials.
4. Materials are provided to the contractor even though the contractor is being paid to provide them. (Office space, furniture, word processors)
5. Unsuccessful bidders usually become subcontractors after the contract is awarded.
6. Contractors are paid twice for the same items/services and there is no attempt to recoup the overpayments.
7. The labor of Agency employees is used to perform parts of contracted work.
8. Contract files are either incomplete or missing required documents. (Follow up)

9. Contract documents are altered, backdated, or modified to cover deficiencies. Demand originals.
10. Accounting reconciliation are not performed regularly relative to:
  - a. Contract payments
  - b. Daily transactions
  - c. Inventory
11. Government supplies and equipment are being shipped to non-Government addresses. (Diversion or substitution)
12. Fictitious or inordinate time frames and dates are entered on contractor records (e.g. gasoline, vehicle, maintenance, inspection, or receiving reports)
13. Contract deviations by means of changes requested and granted immediately after contract award.
14. Used or inferior products are substituted for the product actually ordered.

#### Defective Pricing

Contractors who inflate consultant salary histories and the pyramiding of commodity costs by inflating supplier prices through associated "middle men."

Fraud Indicators include:

1. Persistent defective pricing.
2. Repeated defective pricing involving similar patterns or conditions.
3. Failure to correct known system deficiencies.

4. Failure to update cost or pricing data with knowledge that past activity showed that prices have decreased
5. Specific knowledge, that is not disclosed, regarding significant cost issues that will reduce proposal costs. This may be reflected in revisions in the price of a major subcontract, settlement of union negotiations that result in lower increases on labor rates. etc.
6. Denial by responsible contractor employees of the existence of historical records that are subsequently found.
7. Utilization of unqualified personnel to develop cost or pricing data used in estimating process.
8. Indications of falsification or alteration of supporting data.
9. Distortion of the overhead accounts or base information by the transfer of charges or accounts that have a material impact on Government contracts.
10. Failure to make complete disclosure of data known to responsible contractor personnel.
11. Protracted delay in release of data to the Government to preclude possible price reductions.
12. The employment of people known to have previously perpetrated fraud against the Government.
13. Unusual or unnecessary use of NVOCC shippers or obscure suppliers.
14. Inflated or unusual ocean freight or insurance charges.
15. Excessive or prohibited commodity transport and/or storage charges.
16. Identical or nearly identical high salary history data on employees or consultants.

### Collusive Bidding and Price Fixing

Collusive bidding, price fixing or bid rigging, are commonly used interchangeable terms which describe many forms of illegal anti-competitive activity. The common thread throughout all of these activities is that they involve any agreements or informal arrangements among independent competitors, which limit competition. Agreements among competitors which violate the law include but are not limited to:

- 1) Agreements to adhere to published price lists.
- 2) Agreements to raise prices by a specified increment.
- 3) Agreements to establish, adhere to, or eliminate discounts.
- 4) Agreements not to advertise prices.
- 5) Agreements to maintain specified price differentials based on quantity, type or size of product.

The following list of indicators is intended to facilitate recognition of those situations which may involve collusive bidding or price fixing. In and of themselves these indicators will not prove that illegal anti-competitive activity is occurring. They are, however, sufficient to warrant referral to appropriate authorities for investigation. Use of indicators such as these to identify possible anti-competitive activity is important because schemes to restrict competition are by their very nature secret and their exact nature is not readily visible.

Practices or events that may evidence collusive bidding or price fixing are:

1. Bidders who are qualified and capable of performing but who fail to bid, with no apparent reason. A situation where fewer competitors than normal submit-bids typifies this situation. (This could indicate a deliberate scheme to withhold bids.)
2. Certain contractors always bid against each other or conversely certain contractors do not bid against one another.
3. The successful bidder repeatedly subcontracts work to companies that submitted higher bids or to companies that picked up bid packages and could have bid as prime contractors but did not.

4. There is an apparent pattern of low bids regularly recurring, such as corporation "x" always being the low bidder in a certain geographical area or in a fixed rotation with other bidders.
5. Failure of original bidders to re-bid, or an identical ranking of the same bidders upon re-bidding, when original bids were rejected as being too far over the Government estimate.
6. A certain company appears to be bidding substantially higher on some bids than on other bids with no logical cost differences to account for the increase, i.e., a local company is bidding higher prices for an item to be delivered locally than for delivery to points farther away.
7. Bidders that ship their product a short distance bid more than those who must incur greater expense by shipping their product long distances.
8. Identical bid amounts on a contract line item by two or more contractors. Some instances of identical line item bids are explainable, as suppliers often quote the same prices to several bidders. But a large number of identical bids on any service-related item should be viewed critically.
9. Bidders frequently change prices at about the same time and to the same extent
10. Joint venture bids where either contractor could have bid individually as a prime. (Both had technical capability and production capacity.)
11. Any incidents suggesting direct collusion among competitors, such as the appearance of identical calculation or spelling errors in two or more competitive bids or the submission by one firm of bids for other firms.
12. Competitors regularly socialize or appear to hold meetings, or otherwise get together in the vicinity of procurement offices shortly before bid filing deadlines.
13. Assertions by employees, former employees, or competitors that an agreement to fix bids and prices or otherwise restrain trade exists.
14. Bid prices appear to drop whenever a new or infrequent bidder submits a bid.

15. Competitors exchange any form of price information among themselves. This may result from the existence of an "industry price list" or "price agreement" to which contractors refer in formulating their bids or it may take other subtler forms such as discussions of the "right price."

16. Any reference by bidders to "association price schedules," "industry price schedules," "industry suggested prices," "industry-wide prices" or "market-wide prices."

17. A bidder's justification for a bid price or terms offered because they follow the industry or industry leader's pricing or terms. This may include a reference to following a named competitor's pricing or terms.

18. Any statements by a representative of a contractor that his company "does not sell in a particular area" or that "only a particular firm sells in that area."

19. Statements by a bidder that it is not their turn to receive a job or conversely that it is another bidder's turn.

#### Cost Mischarging

Cost mischarging occurs whenever the contractor charges the Government for costs which are not allowable, not reasonable, or which cannot be directly or indirectly allocated to the contract. The fraud most frequently encountered is called an "accounting mischarge." An accounting mischarge involves knowingly charging unallowable costs to the Government, concealing or misrepresenting them as allowable costs, or hiding them in accounts (such as office supplies) which are not audited closely. Another common variation involves charging types of costs, which have their limits such as bid and proposal costs, or independent research and development costs) to other cost categories. Labor costs are more susceptible to mischarging than material costs because the employees' labor can readily be charged to any contract. When a labor cost is mischarged, so are the associated overhead expenses. Overhead costs are allocated to labor costs based upon an overhead rate or percentage. Overhead costs usually exceed 100 percent of the labor cost. Therefore, any mischarging on labor rates also impacts upon overhead charges, which ultimately results in a greater than double loss to the Government

Fraud indicators include:

1. Excessive or unusual labor charges by home office personnel.
2. Abrupt changes in labor charge levels for no apparent reason.

3. Labor time and charges inconsistent with project progress.
4. Inability of contractor to immediately supply time cards upon demand.
5. Time and/or charge cards that show consistent erasures or alterations.
6. Time cards made out by the supervisor and not by the individual employee.
7. Low level work charged to high level wage earners.

#### Product Substitution

The term product substitution generally refers to attempts by contractors to deliver to the Government goods or services which do not conform to contract requirements, without informing the Government of the deficiency, while seeking reimbursement based upon alleged delivery of conforming products or services.

Fraud Indicators include:

1. The non-delivery of supplies paid for pursuant to fast pay procedures.
2. The delivery of look-alike goods made from non-specification materials.
3. Materials that have not been tested as required by the contract specifications.
4. Providing foreign made products where domestic were required.
5. Boxes with part of the label consistently obliterated. ("Made in Hong Kong" marked out.)
6. Commodities which are consistently defaced in the same area (metal wood files or tools with grind marks or wooden hammer handles with sanding marks).
7. Machines with I.D. or specification plates removed.
8. Any commodity which appears used when new was ordered.
9. Multiple commodities where some appear different from others (2 dozen hacksaw blades with the first and last blade in package made in the U.S. and the remainder made in India).

11. Any commodity purchased domestically, but originally shipped from a foreign port.
12. Missing source origin documentation.

### Progress Payment Fraud

Progress payments are payments made as work progresses under a contract based upon the costs incurred, the percentage of work accomplished, or the attainment of a particular state of completion. Fraud in progress payments occurs when a contractor submits a progress payment request based on falsified direct labor charges, on material costs for items not actually purchased, or on falsified-certification of a stage of completion attained or of work accomplished.

Fraud Indicators include:

1. Firms with cash flow problems are the most likely to request funds in advance of being entitled to them. Progress payments which do not appear to coincide with the contractor's plan and capability to perform the contract are suspicious. This could indicate the contractor is claiming payment for work not yet done.
2. Another type of contractor fraud in this area is to submit a progress payment claim for materials which have not been purchased. The contractor may be issuing a check to the supplier, then holding it until the Government progress payment arrives. One way to confirm this irregularity is to check the cancellation dates on the contractor's checks. If the bank received the check about the same time or later than the contractor received the progress payment, the check was probably held.

Criminal and Regulatory Violations by Employees

Fraud indicators include:

1. Employees, including contractors and foreign nationals, who continually circumvent established procedures.
2. Employees who initiate actions without proper prior approval.
3. Sloppy handling of cash or commodities should always be an area of concern.
4. The awarding of a contract in any fashion outside of the letter and spirit of established procedures.
5. Improper access to computer terminals or data.
6. Unusual or extravagant behavior or spending.
7. Unusual patterns of taking leave.
8. Unusual or extravagant amount of mail sent to particular employees.
9. Cash not turned in properly.
10. Actions that tend to obstruct an audit trail.
11. Unusual or unauthorized interaction between an employee and bidder or contractor.
12. Frequent or unusual and/or unexplained travel.
13. Unusual and/or unexplained possession of large amounts.
14. Abrupt change in living style.
15. In short, actions that are contrary to regulation, good business practice, or common sense can be indicators that something may be wrong.

## **DETECTING FRAUD IN PROJECTS AND PROCUREMENTS**

The following section describes some schemes by which procurement or contracting frauds have been perpetrated, preventive actions, and methods to detect these schemes to defraud.

### Pre-Award Fraud

#### 1. Rigged Specifications

**Scheme:** The requesting organization, in developing specifications, tailors them to meet the qualifications of one particular company, supplier, or product. This applies mostly to procurement of special equipment and fixtures.

**Preventive Actions:** Reviews should be made by managers in order to determine the validity of procurement requirements and specifications and the adequacy of the consideration given to alternate products, features, processes, etc.. The contracting officer should carefully review bids, and maintain close coordination with the requesting office to ensure that all bids are properly considered.

Reviews of bid protests (formal and informal) by the contracting officer would also provide possible indications of problems.

**Detection:** Compare specifications established for a particular procurement with the contractor's description of its product or service. Nearly identical matches would indicate the possibility of rigged specifications.

Other indicators of rigged specifications include:

- a. Receipt of only one bid
- b. One bid significantly lower than others
- c. Sole source procurement
- d. Protests filed by bidders

#### 2. Collusive Bidding

**Scheme:** A group of companies with the capability of providing the same goods or services conspire to exchange bid information on contract solicitations, and to take turns at submitting the low bid. Such action, which may or may not be carried out in collusion with procuring officials, effectively defeats competitive bidding.

Preventive Actions: Heads of procurement offices should periodically review procurement records for patterns of similar contracts awarded alternately to a small group of contractors. Bid tally sheets would be a good source for these analyses.

Contracting officers should be alert to situations where known companies in the area rarely bid on contracts for which they appear to be qualified. Inquiries (telephonic or otherwise) might be appropriate to ascertain why these companies are not bidding.

Contracting officers should pay particular attention to bid protests (formal and informal) as indicators of existing problems.

Detection: Examine contract solicitation files for:

- a. Small number of companies doing similar work on what appears to be a rotating basis
  - b. Awards to companies that reflect a geographic pattern indicating collusive division of territory
  - c. Fairly wide disparity between the winning and losing bids
  - d. Unsuccessful bidders who become subcontractors after contract award.
- One or more of these situations indicate the possibility of collusive bidding.

### 3. Unbalanced Bidding

Scheme: Through collusion, a company bidding on a contract (bidder) knows that one of several items on an invitation for bid will not be performed (called for) under the contract. Therefore, the bidder includes an unreasonably low unit price for this item on the bid sheet. This results in his being the low bidder. After the contract is awarded, the quantity of work that is actually performed on the other items is in excess of what was on the bid. The contractor stands to make more money since his bid price on these items was inflated (but not inflated enough to cause his overall bid price to be too high.)

Preventive Actions: Work statements and specifications should be reviewed by someone who is thoroughly familiar with the goods or services being procured.

Cost and price analysis work obtained by the contracting officer should be documented, and should include comparisons of individual items. Explanations should be sought for all items with a wide variance.

In administering contracts, both the contracting officer and the responsible project officer

should ensure that modifications and change orders are for work that was not known or contemplated at the time the contract was awarded.

Detection: Match line items on invitations for bid with actual contract performance to disclose any excessive variances.

Compare amounts bid on individual line items by each bidder to disclose any unreasonably low bids, particularly those items which were not subsequently performed under the contract. Look especially for those situations where a contractor has received repeated awards for similar types of goods or services.

### Contractor Fraud

#### 1. False Claims and Statements

Scheme: This would cover any false information furnished by the contractor, either leading to contract award or related to contract performance. Examples include:

- a. Cost proposal data that is incorrect or less than current or complete.
- b. False representations concerning quality of product being offered or ability to perform adequately and timely.
- c. Billings (including progress payments) not adequately supported by project status or reliable cost data, including:
  - 1) Duplicate or altered invoices used as support for payment.
  - 2) Costs charged to the project that should be charged to another project or to overhead.
  - 3) "Direct cost" from a contract charged to overhead, thereby "distributing the loss" to other contracts.
  - 4) Double billing, i.e., charging employees full-time to two or more jobs.

In one case, a former contractor employee alleged that certain managers directed the mischarging of employees' time from a fixed-price contract to a cost-plus contract.

Preliminary investigation revealed over \$100,000 was mischarged in one corporate department alone. The contractor acknowledged that there was some mischarging. An

investigation revealed substantial mischarging of several million dollars.

Preventive Actions: The contracting officer and technical personnel of the requesting agency should review contractor cost proposals to determine the reasonableness of proposed costs, the necessity for the kinds and quantities of materials and labor proposed, and the contractor's ability to perform adequately and timely.

The project officer should implement a comprehensive monitoring program to help disclose improprieties. This could include, but is not limited to:

- a. Reviewing the progress of work performed
- b. Testing the quality of work performed
- c. Reviewing all billings to ensure that they are for work which has been satisfactorily performed
- d. Being alert to sudden and unexpected cost growth or over-runs.

Audit services, should be utilized to determine the accuracy and validity of contractor claims.

Detection: Reviews should be made of contractor proposals and actual contract costs, as well as program office reports and inspection reports. Independent engineering or other technical personnel should be used to provide advice on such matters as contractor qualifications and project status. When performing such reviews, the following indicators should be considered:

- a. Contract slippage
- b. Modifications to contracts because of contractor inability to perform
- c. Significant increase in price without corresponding increase in work
- d. Substantial subcontracting without the knowledge and approval of the contracting officer
- e. Substantial funds expended on the work by contractor prior to contract award
- f. Sole source procurement with substantial subcontracting
- g. Prime contractor requiring subcontractor to utilize prime's labor and/or equipment

- h. Inadequately supported charges for consultant fees, equipment rental, and travel
- i. Use of employees or consultants with skill levels below that proposed
- j. Inflated unit prices for items from contractor stock

## 2. Failure to Meet Specifications

**Scheme:** A contractor, in order to increase profits, provided goods and/or services that do not comply with contract specifications in quantity and/or quality. Such non-compliance is not always evident because materials omitted from the end products are not readily identifiable. For example, a contractor uses one coat of paint rather than two; pours four inches of aggregate on road surfaces instead of six inches; or makes short deliveries of landfill. Qualitative non-compliance with contract specifications includes using inferior or substitute materials such as watered loads of ready-mix concrete.

**Preventive Actions:** Prevention of non-compliance with contract specifications depends on a comprehensive inspection program. Inspection by the project officer of work performed and materials used should be made at various intervals during the performance of the contract. Periodically, an evaluation should be made of the inspection program to ensure that inspections are following established procedures.

After-the-fact testing can also be useful to discover shortages or inferior quality of materials used (core borings, chemical and stress analysis, etc.). Such testing can be performed by technically-qualified personnel of the requesting organization i.e., engineers, technicians, etc.).

**Detection:** Obtain and review inspection reports to determine whether the work performed and materials used in a project were inspected and considered acceptable. A lack of such inspections indicates potential problems in meeting contract specification.

Request assistance from independent technical personnel (i.e., engineers, technicians, etc.) to perform after-the-fact testing of quality and quantity of materials used and work performed, to determine compliance with contract specifications.

## 3. Falsification of Government-Furnished Property Records

**Scheme:** The contractor falsifies its records showing non-use of Government-furnished property when, in fact, the property is being used on non-Government work. One investigation revealed that a contractor, with a contract to maintain copying equipment for

the Government, falsified records to show use of Government-furnished parts and repairs made, when the repairs actually were not being made. The parts were subsequently used to repair private machines or were sold. The contractor also claimed that the needed parts were not in the Government-furnished inventory when, in fact, they were. He then purchased the parts, adding overhead and profit to the item.

Preventive Actions: The contracting officer should ensure that contractors provided with Government-furnished property utilize adequate property management controls.

The project officer should monitor the contractor's use of Government-furnished property through periodic on-site inspection of the contractor's operation.

Detection: With the assistance of independent technical Government personnel (i.e., engineers, machinists, etc.) inspect the contractor's plant to determine whether the contractor's non-Government work requires the use of any of the Government-furnished property provided. If Government property is furnished, review the contractor's records to see if the use of the property is recorded.

#### 4. Co-Mingling of Contracts

Scheme: A company is awarded separate contracts for various efforts, i.e., partition contracts, ceiling contracts, electrical contracts, painting contracts, flooring contracts, etc. Each contract has provisions to allow for items, which are in the other contracts. Through collusion, the contractor can bill for the same work on each of the contracts. The requesting agency writes similar work orders under each contract, thus facilitating the duplicate billings.

Preventive Actions: The approving official in the requesting agency should review contracts prior to award to ensure that statements of work to be performed are not duplicated in other procurement. If more than one location is involved, the amount and type of work to be performed at each location must be clearly specified.

The contracting officer should identify contractors holding more than one contract having the same or nearly similar work statements. Billings on contracts so identified, should be especially monitored by the contracting officer and the project officer to disclose duplicate

payment possibilities. Inspection reports should be required to accompany billings to ensure that work is acceptable and conforms to specifications.

Detection: Identify contracts awarded to the same company and determine whether they run concurrently and if each provides for the same efforts.

Review documentation supporting contractors' billings for similar efforts performed under more than one contract by the same contractor.

When auditing contractors' records, check for multi-contract awards.

## 5. False Invoices

Scheme: Where contracts provide for the continued supply of merchandise over a period of time, invoices may be inflated or may be submitted for goods not delivered. This situation is particularly applicable to open-ended purchase agreements.

Preventive Actions: Purchases should be reviewed to ensure that unit prices are not improperly increased by the supplier.

Invoices should be matched against official receiving documents. Payments should not be made without such documentation.

Inventories should be periodically made by the requesting agency to verify items on-hand against actual purchases.

Detection: Account for purchases through comparison of physical inventory with booked purchases.

Determine reasonableness of quantities purchased in relation to the particular office or user.

Check reasonableness of booked prices to disclose inflated invoices

Verify receipt of items by checking receiving documents.

## 6. Duplicate Contract Payments

**Scheme:** The contractor submits copies of the same invoice for payment, or submits more than one original invoice for the same goods or services. This may be accomplished through collusion between the contractor and the requesting agency or by a certifying officer processing a copy of a previously submitted invoice.

**Preventive Actions:** Payments should be made only against original invoices.

Accounting personnel should be trained to detect duplicate or fraudulent documents. In cases where a document is suspect, the payment file should be searched for an identical document previously paid.

The controller's office should maintain a record of contract amounts approved for payment and periodically reconcile this data to the official financial record of payments made under the applicable contracts. As a minimum, this reconciliation should be made at the completion of each contract.

On fixed-price contracts, verify payments recorded in the accounting records against the project officer's records of amounts approved for payment, and match percent of physical completion against percent of dollar completion.

## 7. Change Orders Abuse

**Scheme:** A company bidding on a contract, in collusion with personnel from the requesting organization submits a low bid to ensure receiving the contract award. However, the company has been assured that change orders will be issued during the life of the contract to more than compensate for the low bid. After the contract is awarded, the contractor and the procuring official share in the excessive reimbursements resulting from the numerous and/or high dollar value change orders issued against the contract.

**Preventive Actions:** Managers of requesting agencies and heads of procurement offices (management officials) should be alert to contracts where numerous and/or high dollar value change orders are proposed or issued. Such actions are indicators of possible improprieties.

The management officials should carefully review all proposed change orders involving price increases to ensure that the additional monies are for necessary additions to the work scope of the contract, and not merely to increase the contractor's profit.

The contracting officer should determine the reasonableness of excessively low bids through analysis of independent Government estimates and cost and pricing data.

Detection: Analyze contract change orders for the addition of new items and for significant increases in scope, quantities, and price of existing contract items.

Look for indicators of change order abuse such as: (1) an employee directly involved in both determining requirements and procuring the item, or taking a job with the contractor; (2) high turnover rate among procurement personnel; (3) request for change order signed at a higher level than that of the original procurement request and (4) request(s) for change order coming from an organization different from the one requesting the procurement.

### Procurement Fraud by Government Personnel

#### 1. Excessive Small Purchases of Tools, Supplies, etc.

Scheme: Items are purchased and subsequently diverted for personal use. This includes items which are not required or quantities purchased in excess of requirements. It also includes items which are required but taken for personal use and need replacement.

Preventive Actions: Require after-the-fact reviews of small purchases by the manager of the agency making the Purchases to validate their reasonableness.

A program should be established to monitor central supply withdrawals and procurement by on-site contractors.

Once or twice a year, the manager should have prepared a list of items purchased throughout the period for comparison to the number of people using the supplies, tools, or small equipment. Any excessive purchases identified for which the actual items purchased cannot be located, would indicate possible diversion of the items for personal use.

Detection: Obtain a listing of small purchases made over a specified period of time and re-arrange the list by name of purchaser and/or organizational unit.

Analyze the information obtained above to determine whether quantities of items purchased are reasonable considering the size of the organization and the length of time between purchases of individual items.

#### 2. Split Purchases

Scheme: A procurement is split into two or more purchase orders to circumvent the agency

procurement regulations which permit negotiation without formal advertising if the aggregate amount does not exceed a specified amount. This could be perpetrated by a contracting officer or the requesting agency.

Preventive Actions: Managers of the requesting agency and the procurement office should make periodic reviews of purchase orders, grouped by contracting officers who issued them and for specific periods of time, to ascertain whether:

- (1) identical items were purchased in different quantities, either simultaneously or within short periods of time, or
- (2) a project was split by type of work (i.e., one purchase order for material and another for labor).

Contracting officers should be especially alert to consecutive procurement requests for identical items from the same contractor, each for the amount requiring competitive procurement.

Utilize computer resources to group the payments by vendor, and manually check invoices for split purchases.

### 3. Phantom Contractors

Scheme: An invoice(s) from a non-existent company is submitted for payment by either accounting or project personnel. This fraud could be perpetrated by accounting personnel or someone responsible for administration of the project.

Preventive Actions: Prior to making payments, accounting personnel should verify the authenticity of contractors by comparing unknown names to the agency listing of approved contractors.

### 4. Altered Receipts/Vouchers for Cash Fund Reimbursement

Scheme: Cashier alters a voucher after making payment against it by adding another number to the amount paid (i.e., \$40 can be changed to \$140). The cashier then submits the altered voucher, together with others, to accounting for replenishment of the cash fund and pockets the excess replenishment (\$100). Although the Accounting Office

maintains a copy of such vouchers separately from the cashier, the two copies are only occasionally matched because of the large volume of individual transactions involved.

A payee could "rip-off" the system by submitting a voucher with falsified information, and

altering receipts and other documentation to support the false claims.

Preventive Actions: Accounting personnel should be sensitized to the possibility of and be trained to detect altered documents.

Accounting personnel should routinely match vouchers, which they maintain, with supporting cash fund replenishment vouchers to ascertain that no improper alterations have been made.

Detection: Scrutinize vouchers and supporting documentation for evidence of changed figures. This would include differences in pens used or thickness of marks on paper, consistency in pressure marks on reverse side of invoice, and reasonableness of total invoice to individual items purchased.

On a sample basis, make comparisons of accounting's copy of vouchers with the cashier's copy.

#### 5. Duplicate Payments from Both Voucher and Cash Fund

Scheme: A vendor submits the original of an invoice to accounting for payment while the purchaser, either on his own or through collusion with the vendor, collects for the same item from the cash fund. A cash register tape, vendor invoice or other document may be used for reimbursement from the cash fund.

Another technique would be for the purchaser, through collusion with the vendor, to issue two invoices for item(s).

Preventive Actions. Management should monitor purchases by periodic after-the-fact management or supervisory review.

All documents should be pre-numbered and properly accounted for.

Detection: Compare payments of Vouchers against payments made through cash funds using for comparison the names of purchasers, vendors, and items purchased. This can be done manually or by computer if the information is keypunched for this specific purpose. Comparisons can also be made within cash fund disbursements for duplicate payments.

Arrange vouchers (manually or by computer) in numerical or chronological order and look for duplications. In those cases where duplicate payments appear to exist, verify the physical existence of the items purchased.

#### 6. Duplicate Payments from Cash Fund

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Scheme: More than one original invoice, or an invoice and a shipping/receiving ticket for the same goods (small purchases), are submitted for reimbursement by the cash fund.

Preventive Actions: Emphasize to cashiers the importance of honoring only original invoices as payment documents. They should also be alerted to the potential for submission of more than one original invoice for the same item.

Cash fund transactions should periodically be reviewed to identify payments for identical items, quantities and amounts.

Managers of program or operations offices should periodically review cash fund transactions involving their activities for reasonableness of quantities of individual items paid for through the cash fund. Unusually large quantities of a single item might indicate the possibility of duplicate payments.

Detection: Review payment documents for a specific time period, checking for same payee, amounts paid, and items purchased. Be especially alert to payments supported by copies (carbon or Xerox) of invoices rather than originals.

Unusually large quantities of a single item purchased over a short period of time may indicate the possibility of duplicate payments.

Bribery and Illegal Gratuities

Any of the above examples involving collusion could also involve bribery or illegal gratuities.

## **FRAUD INDICATORS AND FRAUD SCHEMES**

The following paragraphs outline situations that may indicate that a fraud is or has been committed against your agency and provide examples of particular schemes. The information is intended to sensitize managers to the potential for fraud in day-to-day situations. The indicators may also help identify systemic weaknesses at operational units.

### **1. Co-mingling of Contracts:**

A company is awarded separate contracts for various efforts, e.g., electrical contracts, painting contracts, flooring contracts, etc. Each contract allows charges for services or items used in the other contracts as well. Through collusion, the contractor can bill for the same work or supplies on each of the contracts.

### **2. Rigged Specifications:**

The requesting organization tailors specifications to meet the qualifications of one particular company, supplier, or product.

### **3. Collusive Bidding:**

A group of companies with the capability of providing the same goods or services conspire to exchange bid information on contract solicitations and then take turns at submitting the low bid, effectively defeating competition. Such action may be carried out in collusion with procuring officials. Following are some indicators of bid rigging:

a. Identical bids are received.

b. A number of bids are received that are much higher than published costs of previous contracts of the same type, or of previous bids by the same firms for similar contracts.

c. Fewer firms bid than would normally be expected from that industry:

d. There is an inexplicably large gap between the winning bid and all other bids.

e. Apparent recurring patterns of low bids, such as a corporation always winning a bid in a certain geographical area, or in a particular rotational sequence vis-a-vis other bidders.

f. The successful bidder subcontracts work to companies that submitted higher bids on the

same project.

g. Bids are very close on nonstandard items with no suggested retail price.

h. There is a correlation between the contractors that win the bids and the size of the contracts.

i. Competing contractors regularly socialize, or contractors and Government procurement personnel socialize.

#### 4. Companies Conducting Business under Several Names:

Company officials may attempt to conceal a reputation of poor contract performance by conducting business under several different names simultaneously. Such companies may also submit more than one bid or offer in response to a solicitation, thus restricting competition.

#### 5. Conflict of Interest Situations:

A contract is awarded to a company owned or controlled by a government employee.

An employee's conduct creates or gives the appearance of a conflict. For example: The employee (or a family member) has business dealings or a close social relationship with a contractor or potential contractor; or the employee or family member receives gifts, entertainment, favors, or offers of employment from an actual or potential contractor.

#### 6. Failure to Properly Monitor Contract Performance:

Without adequate inspection or through collusion, contractors providing goods and services have an opportunity to be paid for more work or supplies than actually delivered. For example, work orders for the removal and installation of partitions, electrical outlets, telephones, plumbing, etc., can be compromised by inflating the quantities of items removed or installed.

7. Failure to Meet Specifications:

A contractor increases profits by providing goods or services that do not meet contract specifications. Such action is often difficult to detect because materials omitted from end products are not readily identifiable. For example, a contractor uses one coat of paint instead of two; uses watered loads of concrete installs inferior memory chips in computers; or uses inferior automobile replacement parts.

8. Same Individual Authorized to Order and Receive for Goods and Services:

Persons controlling both the ordering and receiving functions can arrange for diversion of supplies or services for their own benefit or sign for "phantom", incomplete, or technically inferior shipments in exchange for money or favors from the contractor.

9. Unvarying Patterns in Small Purchases:

Unvarying patterns in small purchases may indicate that a buyer is awarding contracts to favored vendors without soliciting competitive offers from additional firms. The buyer may also be entering fictitious competitive quotations and consistently awarding a favored vendor at inflated prices.

10. Frequent Complaints by Users of Supplies or Services:

Frequent user complaints of poor quality or level of performance of supplies or services provided under a contract may indicate that contractors are delivering something less than you are paying for. The cause may be a poorly written contract, weak contract administration, or fraud involving contractors and employees.

11. Service Contract Specifications Include Bid Schedule Items for which there is little or No Requirement:

The government may be paying more than necessary for contract services when bid items for which there is little or no demand are included in annual requirement contracts. Individuals working in requirements or contracting activities may be in collusion with incumbent contractors by including such items in bid solicitations. As a result, incumbent contractors gain an unfair advantage by bidding "no charge" or "token" prices for the items, thereby restricting competition.

For example, on a solicitation, which has 30 bona fide separate line items on the schedule, procurement activity personnel in collusion with an incumbent may add 5 line items for which they know there will be no demand. Competing contractors, unaware of the collusive situation, will bid each of the items based upon their estimate of actually providing the service. The incumbent contractor will bid little or nothing, thereby giving that firm the low aggregate bid. This unfair advantage restricts competition and enables the incumbent to overcharge for the bona fide items

12. Splitting Large Requirements:

Contracting or requiring activity personnel may be splitting requirements into small purchase orders to avoid the scrutiny required for larger dollar value contracts. Splitting the requirement may waste funds by losing the economic advantage of volume purchasing. Favoritism or other forms of fraud are easier to conceal when small purchase methods are used.

13. Government Estimates and Contract Award Prices are Consistently Very Close:

Employees may be releasing advance purchasing information to favored contractors, in violation of conflict of interest, bribery, or other statutes. Additionally, the unauthorized release of advance information may be indicated when the same contractor receives a preponderance of contract awards for a particular requirement, even when competition exists.

14 Contractor Complaints of Late Payment by the Agency:

Complaints by contractors or suppliers that they are not being paid in a timely manner may indicate fraudulent manipulations and diversion of Government resources through supply or finance operations.

15. Mischarging Costs Among Contracts:

A contractor shifts costs, usually labor charges, from an unprofitable contract (either fixed price or cost reimbursement type) to one or more other cost reimbursement contracts. Typically, the employee time cards are fraudulently made out to show the false cost reimbursement contract accounting code.

16. Duplicate Payment:

A vendor submits the original voucher for payment, while the purchaser, acting alone or in collusion with the vendor, collects for the same item from the cash fund.

17. Downgrading Serviceable Property to Scrap:

With intent to defraud the Government, property in serviceable condition may be downgraded to scrap. When the property is written off as scrap, it loses its identity as an item, simplifying the theft of the item.

18. Abnormal Increase in Consumption of Fuel or Supply Items:

Abnormally high consumption of fuel or common supply items such as automotive parts, tools, and individual equipment indicates the items could have been diverted for personal use or resale.

19. Poor Physical Security:

Conditions such as poor warehouse lighting, insecure storage areas, and private vehicles permitted to park adjacent to storage areas are examples of weaknesses that encourage or contribute to diversion of Government property.

20. Receipt of Items that cannot be traced to a Valid Requisition:

Items received that cannot be traced to a valid requisition could have been ordered for personal use or resale and the resulting paperwork destroyed.

21. Failure to De-obligate Canceled Purchase Orders:

This situation usually indicates that employees are attempting to transfer funds from one fiscal year to another or that employees are receiving a refund for canceled items and are not depositing the refund with the Government.

22. Overstatement of Shipment Weights:

Carriers may be defrauding the Government by artificially inflating the weight of a shipment. Carriers use the following methods to "bump" or increase the true weight of a shipment:

a. Body Bumping: A lightweight driver sits in the van when getting the tare weight and a heavier driver gets the gross weight of the van. The net gain could be as much as 100 pounds.

b. Fuel Bumping: Getting the tare weight with less than a full tank of gas and the gross weight with a full tank. If the tank was 1/4 full for tare and full for gross, a net increase of 450 to 500 pounds could result.

c. Packing/Equipment Bumping: Getting the tare weight without the required packing/equipment (blankets, dollies, ladders, snow chains, etc.) and getting the gross weight with the equipment included could result in a net increase of several hundred pounds.

d. Double Billing on Small Shipments (500 to 3,000 pounds): Getting two tare weight tickets for the truck, picking up the two small shipments, getting two gross weight tickets for the combined weight of both shipments, then submitting both tickets for payment. The increase in weight would be equivalent to one of the shipments.

e. Weight Bumping: Adding pallets, lead ingots, etc. to the shipment to equal the weight allowance of the employee. The net increase can range from several hundred to several thousand pounds.

f. False Tickets: Paying the weight master to provide a false weight ticket or having a supply of blank or false weight tickets. If blank tickets are used, the weight will usually be handwritten rather than printed.

g. Switching Trucks: Switching from a light truck/tractor to a heavier one after obtaining the tare weight.

h. Excluding Crating Materials: Crating materials used to protect fragile or high value items are not included when obtaining the tare weight. This crating material, usually lumber, could weigh several hundred pounds if a shipment includes several items requiring protection.

### 23. Failure to Conduct Inventories or Alteration of Inventory Records:

Employees may be mismanaging the equipment/supply inventory system to permit the systematic theft of Government property.

### 24. Excessive Parts Replacement in Vehicle Maintenance:

Maintenance personnel may charge unnecessary parts to vehicle maintenance and divert these parts for personal use or gain. In one example, vehicle maintenance records identified 14 tire replacements in 8,148 miles, five new batteries in 100 miles, and seven

tune-ups in 8,000 miles.

25. Government Funds Used for Replacement Parts in New Vehicles:

New vehicle warranties usually provide for replacement of many failed parts at no cost to the Government. If vehicle records show that parts procured with Government funds are being used in new vehicles, there is a possibility that the parts are being spent unnecessarily.

26. Cashiers Fail to Return a Copy of Paid Travel Vouchers to Employees:

Cashiers may be embezzling funds by shortchanging employees if the cashiers do not return a copy of paid travel vouchers to the payee. Cashiers have attempted such embezzlement when making payments by folding under the "Amount Paid" corner of the voucher so the payee does not see it and by later disposing of the member's copy of the voucher.

27. Disbursement not Processed into the Accounting System on a Timely Basis:

Employees could be making unauthorized disbursements and trying to hide or delay detection of the disbursements by not processing transactions in a timely manner.

28. Excessive Numbers of Travel Claims for Expenses that Can Be Accepted without a Supporting Receipt:

Employees may be submitting fraudulent travel vouchers by including fictitious expenses which do not have to be supported with a receipt (e.g., taxi fares). Excessive numbers of such expenses in vouchers may indicate fraudulent claims.

29. Repeated Changes to Timecards/Excessive Overtime:

Repeated erasures or changes on an individual's card, amended timecards, repeated instances of prior periods of overtime claimed, excessive amounts of overtime earned, or little or no use of annual leave may indicate possible timecard manipulation by an employee in a timekeeper position.

30. Employee Refuses Promotion, Leave, or Job Changes:

The employee may oppose promotion or reassignment to another position because the change might remove the opportunity to obtain illegal gains. The employee may also fear discovery of the illegal activity in the current position.

31. A Single Individual Controls More Than one Key Resource Management Function:

An individual who controls more than one of the key functions and responsibilities associated with any resource management activity is in a better position to exploit the system than one whose responsibilities are limited to a single key area. Most resource management directives stipulate separation of functions as a safeguard against fraud. Violation of such directives by apathetic supervisors or overzealous employees have resulted in numerous instances of fraudulent exploitation of resources.

32. Purchase Orders Being Used for Personal Orders:

Employees may be using Government purchase orders for personal purchases to qualify for the Government discount.

33. Large Year-end Purchases for Nonspecific Items:

Employees may obligate all year-end funds to a local vendor to establish a credit balance account. Future purchases are then made against this account.

34. Inventories Are Mixed to Prevent Identification of Purchase with Special Funds:

Paint purchased for Government-owned quarters may be used for painting leased quarters. Items purchased with office supply funds may be used for quarters.

35. Journal Vouchers Being Used to Transfer "Over-Obligated" Purchase:

Employees in the accounting function may use journal vouchers to transfer small portions of over-obligated balances into purchase orders that were not fully expended.

37. Submission of Copies of Paid Receipts to Collect Reimbursement:

An employee may retain the original and submit multiple copies of the same receipts, thereby receiving numerous reimbursements for the same expenditure.

38. Supervisory Reviews or Computer Edits Are Bypassed:

Large workload backlogs or collusion may cause management personnel to skip supervisory reviews of data to be entered in a computer data base, or special codes may be entered to disable computer edits. Most instances of computer fraud are facilitated by such procedural bypasses.



## **WARNING SIGNS OF FRAUD**

The intent in a financial fraud is to divert or misdirect assets or information, while preventing the disclosure of fraud. These two requirements often cause a trail of irregularities to be left behind. These irregularities may serve to alert the astute, determined accountant, investigator, or manager.

The following are potential fraud indicators:

- 1) Excessive changes in accounting principles or disregard for Generally Accepted Accounting Principles (GAAP).
- 2) Excessive or unjustified changes in accounting personnel may be an attempt to prevent employees from learning too much.
- 3) The refusal/failure to allow an independent audit or subtle attempts to direct the audit or investigation may indicate an attempt to hide problems.
- 4) The excessive destruction of controlled documents should not occur, although error is often given as the excuse. Be alert for out of sequence invoices in files or unnumbered invoices where serial numbering is the rule. Possibilities include stolen or counterfeited documents.
- 5) An excessive number of photocopies of invoices in files should lead to further inquiry. It is a simple matter to alter approved invoices with 'white-out' or similar correction fluid and copy the invoice, destroying the original. The attempt may be to manipulate the audit trail or commit the fraud via the alteration. Secure external and internal copies for comparison. Duplicate copies of supplier invoices could also indicate the possibility of multiple payments of the same invoice with the checks diverted.
- 6) Excessive business checks to cash or individuals. Although some checks to cash and individuals may be necessary for convenience, an excessive percentage is questionable, since businesses do business with one another, and checks made directly payable to the intended party are a better receipt. When such checks show second endorsements they are highly suspect.
- 7) A pattern of second endorsements on payroll checks may indicate the normal practice of

a business cashing its employees' salary checks, etc. However, it may also indicate cash schemes or other illicit activity.

A typical second endorsement scheme involves endorsing a fictitious employee's paycheck and issuing cash. Another variation involves paying a check in a certain amount, e.g., \$500, for the purchase of material that will cost less, e.g., \$200. The recipient endorses the check and returns it to the issuer, who gives the recipient the agreed upon lesser sum, e.g., \$200. The canceled check will be for the larger amount, and the cash voucher or disbursements book will show the larger amount going out, e.g., \$500. The net result is evidence of paying a certain amount, while allowing the businessman or employee to pocket \$300.

8) Periodic or excessive conversion of cash for exchange items may be part of a scheme to divert assets and hide trails. (Exchange items include cashier's checks, money orders, etc.

9) Excessive cash transactions are a poor business practice. Like item 6, the question is why?

10) If assets are sold or transferred for what appears to be less than adequate consideration this may indicate a sham transaction with no economic reality. Businesses exist to make a profit and anything in contravention of this goal should be questioned.

11) Assets are sold but possession is maintained. A real sale or a sham transaction? More than a buyer seller relationship?

12) Post-dated checks are a possible indication of cash flow problems, or a check fraud.

13) Lack of sufficient vouchers and supporting documents indicate that purchases may not have actually occurred or that merchandise may have been stolen.

14) Excessive bad debt write-offs may indicate a scheme for an employee to split kickbacks with a co-conspirator on the outside.

15) Excessive spoilage/damaged goods may indicate a scheme between certain employees and purchasers/shippers similar to the bad debt write-off.

16) Excessive or unpaid loans to non-critical employees should be very carefully examined, for they may not be loans. Documents attesting the character of the payments

as a loan, even to officers, are inadequate where fraud is suspected. All the documentation should be there. Look for the history of repayment.

17) Encumbrances and liens shortly before bankruptcy could indicate the possibility of liens by related companies or sham transactions using shell corporations to protect assets and cloud ownership claims; possibility of a planned or fraudulent bankruptcy.

18) Excessive or insufficient freight expense relative to inventory purchased or to sales may indicate that purchases have been paid through means not reflected on the books or inventory purchased or sales made for unrecorded cash. This may also indicate the possibility of diverted assets and/or a hidden operation by management or employees.

19) Where inventory is a material income-producing item, concern should arise when component ratios are out of acceptable limits.

e.g. Assume one item X is purchased for each item Y to make product Z. Records reflecting the purchase of 1000X and 500Y should require further examination.

e.g. Significant increase in power consumption in a manufacturing facility without a corresponding increase in production or revenue. This type of observation would apply to other ratios that are out of line with past history or industry norms (gross profit ratio, etc.).

20) Failure to reconcile bank statements or a conflict of the duties on the part of the person performing the reconciliation (manages cash and performs reconciliation, etc.).

21) An excessive number of checking accounts without a true business purpose could possibly indicate good local and/or out-of-town cash management techniques of paying from a distant bank, or it may indicate a check-kiting scheme. For the latter, cash reconciliation is a must.

22) An excessive number of employees relative to production or a change in employees without a corresponding need/revenue increase is possibly indicative of a ghost payroll scheme for generating cash. It may be a fraud against a customer or government where contract terms call for "cost plus."

23) Business dealings with no apparent economic purpose are out of the ordinary, since businesses exist to make a profit. Deals with companies with little or no economic viability fall in the suspect category.

- 24) Excessive/questionable dealings with subsidiaries should alert the auditor or investigator to the possibility of questionable expenses being passed along and/or the use of payables to free up cash, etc. It also may be an attempt to generate the appearance of revenue.
- 25) Use of management fronts, such as interlocking directorates, alter-egos, etc., to conceal true ownership control and thus conceal organizational conflicts of interest.
- 26) Inappropriate trends in relation to other events, such as a decline in the number of quality control inspectors when a large contract is received should be questioned.
- 27) A significant lack of internal controls may indicate that a questionable practice is being hidden. Remember that one of the basic rules is that businesses exist to earn a profit. Look for actions counter to this goal.
- 28) The lack of competitive bidding may hide kickbacks or conflict of interest situations.
- 29) Questionable and significant changes in key financial ratios indicate potential problems.

#### Review of Checks and Other Financial Records

Listed below are a few fraud indicators that can be looked for when reviewing contractor or consultant financial records. Certain transactions may indicate "Ghost Payrolls", unauthorized expenses, or other situations which require additional investigation.

1. Compare check numbers against date issued. Checks should be issued in sequence by check number and date.
2. See if more than one check in sequence was issued to the same vendor. It would be an unusual situation for this to occur.
3. Compare computer-generated checks with manually issued checks. This is usually indicated by a different series of check numbers. The method by which the checks were generated to a specific vendor should be consistent.
4. Check for differences in addresses, such as slightly different post office numbers, incorrect post office numbers or different zip codes for the same address different street numbers or alternating addresses.

5. Look for checks to different vendors going to the same mailing address.
6. Look for checks to different vendors deposited in the same bank account.
7. Deposits of checks made by each vendor should be consistent with the same account
8. Look for checks that are prepared by different typing machines than those before and after the checks in question.
9. Be observant for checks issued in "round" amounts.
10. Checks may normally include the payee's mailing address for use in a "window" envelope. If a check is found where the address is missing or incomplete, it may be an indication that the check was delivered by other than normal means.
11. Hand-written endorsements on the back of business checks should be noted. Most businesses use a stamp indicating "For Deposit Only" or "Deposit to the Account of" etc.
12. Erasures or white-outs should always be suspect.
13. Folded or "long-held" checks should also raise suspicion.

Compare information from checks with addresses and expenditures shown on the vendor list. If time permits, select a three-month period and review every check issued. Document and analyze as discussed above. In addition, verify that all checks are accounted for and that they were issued in sequence. Also, check all payees shown on checks to see if they are shown on the vendor list. If any checks are missing or any payees are not on the vendor list, this should be a suspicious indicator. If a certain check is identified as being fraudulent, look for checks issued immediately before and after for additional indications of fraud. While surveying the checks, be alert to any other checks that might be suspect.

When reviewing the accounts payable file, look for detailed information regarding individual disbursements to vendors. There should be a file for each vendor and a receipt or bill with the same expense item for each check issued.

Invoices should contain pre-printed, company letterheads with street addresses and telephone numbers. Universal type invoices (easily purchased from a business office supply firm) should be suspect. Legitimate companies generally will have their own letterheads. Be suspicious when post office boxes and street addresses for several vendors are the same or are located in the same general area. Invoices to the same

vendor with sequential serial numbers should be regarded as suspect. Missing files or vague explanations for expenditures often indicate irregular activity.

Review of Assumed Names, Records of Incorporation, etc.

1. Determine names of major corporate executives, staff members, members of the financial accounting departments.
2. Check these names against appropriate register of assumed names, incorporation records, business tax rolls, etc. to identify any businesses these individuals may be associated with.
3. If any businesses are discovered, document the names, addresses, dates of incorporation, and persons signing the records
4. If possible, obtain a complete list of the vendors the company uses with addresses and expenditures for the last several years.
5. Compare the names of businesses identified through checks of assumed names and corporation records, etc. with the vendors on the list. If there are any matches, this would be an indication there is a questionable relationship between the vendor and the other companies.

Situations to look for would include:

- a. Vendors used as a front to launder embezzled funds.
- b. Vendors used to provide legitimate services but at highly inflated prices.
- c. Vendors used to direct business to a member of a family or close associate.