



# The White Paper **TOPICAL ISSUES ON WHITE-COLLAR CRIME**

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## **Reserving the Right to Audit the Suspicious Vendor**

**Right-to-audit clauses in vendor contracts help control fraud and abuse by affording discovery devices in examinations.**

**By Ralph Q. Summerford, CFE, CPA, CVA**  
**President, Summerford Accountancy, PC ([www.summerfordcpa.com](http://www.summerfordcpa.com))**



Management was finally getting worried. On six different occasions, employees in the purchasing department and other vendors of the ABC Company had alerted executives of a cozy relationship between a department purchasing manager and an outside vendor. The company called our firm, we conducted a fraud examination, and their worst nightmares were confirmed: a \$6 million kickback scheme. And it could have been prevented with a simple vendor audit clause in the contract or purchase order.

We requested both the vendor and the vendor's sub-contractor to allow the internal audit department of ABC Company to perform an audit, but both the vendor and the sub-contractor flatly refused. So what could have been a successful recovery by ABC - and possible criminal conviction of the fraudulent vendor - turned into a long and expensive civil lawsuit. ABC Company finally tired of pursuing its claims, abandoned the suit, and licked its wounds.

Determined to not be burnt again, ABC adopted an ethics policy, clearly defining fraud, and now requires all employees - staff and management - to sign annual disclosure statements stating they have reviewed the policy and aren't aware of any violations.

But most importantly, ABC Company now includes a "right-to-audit clause" on every vendor's purchase order. Also, every contract with a contractor or vendor contains a specific provision for the right to audit.

Vendor audit clauses can help control fraud and abuse by affording a discovery device in a fraud examination.

When the right to audit is exercised, the fraud examiner or auditor is generally looking for fraud by vendors and violations of company ethics policies such as:

- faulty or inferior quality of goods;
- short shipments;
- high prices when the goods can be bought directly and/or cheaper from the same or another vendor;
- goods not delivered;
- kickbacks;
- gifts and gratuities to company employees;
- commissions to brokers and others;
- services allegedly performed that weren't needed in the first place, such as equipment repairs; and
- conflicts of interest.

## Obtaining the Right

The buyer usually obtains the right to examine records of a vendor to determine if a fraud or a violation of company policy has occurred through the following methods:

**Right-to-audit agreement** The agreement can be printed on the back of a purchase order, contract, or other procurement form. The clause could be worded as follows on a purchase order:

*"Seller shall establish a reasonable accounting system, which enables ready identification of seller's cost of goods and use of funds. Buyer may audit seller's records anytime before three years after final payment to verify buyer's payment obligation and use of buyer's funds. This right to audit shall include subcontractors in which goods or services are subcontracted by seller. Seller shall insure buyer has these rights with subcontractor(s)."*

If a buyer inserts a right-to-audit clause in a contract, he has a much greater chance to expand definitions and include other compliance provisions for the vendor. (See sidebar.)

**A simple request** If the right-to-audit agreement wasn't included on the procurement form, and the buyer suspects irregularities, he may have to beg the vendor to allow an audit to be performed. If the buyer is a major customer of the vendor, the buyer may be able to wield a big enough stick to obtain permission to look at the records. Otherwise, the vendor may refuse, which leaves the buyer at a crossroad. (Generally, a vendor who refuses to allow a buyer to perform an audit has something to hide.)

Surprisingly, *most vendors will grant the audit!* Even if the vendor is guilty of fraud or an ethics violation, the vendor's management or its owners may be unaware of the impropriety. Furthermore, the vendor may take the audit as an opportunity - while it has the auditor's attention - to voice concerns if the vendor thinks it's being unfairly treated or is seeking more business from the buyer.

Other options for obtaining the right to audit may include: (1) inserting a **specific provision** into a contract that's normally entered into between buyer and vendor, e.g., construction contract or supply contract in addition to the basic right-to-audit clause; and (2) **an audit provision included within a special document** (such as a vendor survey mailed to all new or proposed additions to the vendor master file) that's completed and signed by vendors. And finally, the least desirable option is: (3) **a civil lawsuit in which documents and records are subpoenaed.**

## Right-to-audit Pitfalls

When preparing a right-to-audit clause, a company can fall into a number of pitfalls:

### Pitfall No. 1 - Not Including Mention of 'Reasonable Accounting System'

By including the statement, *"Seller shall establish a reasonable accounting system, which enables ready identification of seller's cost of goods and use of funds,"* the buyer requires the vendor to keep adequate books and records for review. If the statement isn't included then the buyer can't put the vendor on notice that it's watching the vendor carefully. (If the vendor complies with the IRS, then the vendor should have on hand at least three years of records.)

### Pitfall No. 2 - Not Including Right to Determine How Funds were Used

Many companies just include the right to audit as mere assurance that the cost of goods is appropriate. But that won't necessarily include violations of the company's ethics policies through giving of extravagant gifts, entertainment, commissions, referral fees, payments to a broker, kickbacks, or use of facilities and equipment. The failure to include in the contract the right to determine how the funds are used may preclude the buyer from examining the records that would yield the "real information" the buyer wishes to obtain. A vendor could refuse to allow the buyer to look at the chief records the buyer wants to examine, limiting significantly the scope of the proposed audit.

### Pitfall No. 3 - Failure to Expand Audit Rights in Contract

In the right-to-audit provision of the contract it must be clear that the buyer has the right to examine the books and records of the seller to assure that the seller has complied with the contract, and that no employee of the buyer received any funds either directly or indirectly. Additional conditions can then be placed in the contract to allow the auditor to require the vendor to produce its disbursement records.

#### **Pitfall No. 4 - Failure to Withdraw from Audit When Scope is Limited**

When the vendor limits the scope of the audit by not allowing the buyer to look at the "real information," the buyer must seriously consider withdrawing from the audit. When the auditors report to the buyer's management how the vendor has limited the audit by not allowing a review of the "real information," management at that time has the options of threatening or beginning litigation, and/or canceling the contract.

By continuing the audit, the vendor may erroneously represent to others that the buyer's auditors completed an audit and there were no findings. If, on the other hand, all the vendor's records had been opened for inspection to show the vendor's use of the buyer's funds, a completely different result may have been obtained. The necessity to look at all the records can't be overemphasized.

#### **Pitfall No. 5 - Limiting Time for Audit**

Unfortunately, many companies which include a right-to-audit clause in purchase orders, contracts or both, limit the amount of time they give themselves to perform the audit to only a few months. In a complex fraud examination, it sometimes takes years to adequately develop a case. It's reasonable to request that the right to audit be open for at least three years - the minimum amount of time the IRS expects businesses to keep records available for audit and inspection.

#### **Pitfall No. 6 - Failure to Include Subcontractors**

It's important to include the provision for the right to audit subcontractors in any purchase order or contract because in many industries the primary suppliers are likely to subcontract all or portions of the work. In many fraud schemes, it's the subcontractor who has direct ties to the buyer through family, ownership, joint venture, or undisclosed financial interest. It's also not uncommon to find that the vendor has purchased materials or rented equipment from companies the buyer should have contracted with directly at a substantial savings. This is a common method of perpetuating a kickback scheme in which the contractor gives a kickback to a purchasing agent or contract manager for allowing the contractor an exclusive right to handle these duties.

#### **Pitfall No. 7 - Failure to Understand Vendor's Business, Products**

Assuming a vendor audit is going to take place, or the auditors are attempting to review transactions with different vendors, it's vital for the auditors to analyze and understand the vendor's business, its market, pricing structure, and goods or services. The auditors really need to do the research to know these factors. Most importantly, it's essential for the auditors to know the methodology the vendor uses for pricing its goods or services follows industry practices. The auditors could discover their employer may be the major - or only - customer of a vendor! In conflict-of-interest schemes and in many kickback schemes this possibility is more than likely. For example, the fraudster (a purchasing agent or employee of the vendor company) sets up a fictitious company whose only purpose is to prepare invoices at a substantial markup over the cost the buyer could otherwise obtain, and bills the inflated invoices to the buyer. After receiving payment and paying his vendors, the fraudster pockets the excess. The funds are either kept by the fraudster in a conflict-of-interest scheme or a portion of the excess is kicked back to the purchasing agent in a kickback scheme.

The sequential numbering of invoices is an extremely good indicator of these types of schemes. Also, the percentage of purchases from each vendor can be calculated to determine if an unusually large amount of purchases come from any one particular vendor.

It's important to remember that knowledge is absolute power, and where there's smoke, there are mirrors. In order to get a good understanding and feel for dealings with any vendor, transactions with that vendor for their products and services need to be reviewed for at least the previous three years.

#### **Pitfall No. 8 - Failure to Include Additional Warranties as Part of Contract**

As a separate condition of a contract the buyer can include a warranty that none of the funds in the contract were given to any of the buyer's employees in the form of gifts, gratuities, and commissions (or any other form of kickback). In international projects or high-risk areas such as retail businesses, which are prone to kickback and conflict of interest problems be sure to include such vendor contract terms as, "We warrant no gifts or gratuities were given to any of the buyer's employees either directly or indirectly to obtain this contact."

In many countries, the payment of a commission (kickback, brokerage fee, etc.) isn't illegal. Often the vendor will pay a commission, say 5 percent or more, to a third party who will then pass it on to the buyer. (In the U.S., of course, these payments are prohibited under the Foreign Corrupt Practices Act.) While warranties in U.S. federal contracts are normal, be certain they are also included in non-governmental contracts to assure compliance with the vendor's ethics and fraud policies. In kickback cases (especially in the private sector) there aren't any subpoenas or other discovery devices available unless you file a lawsuit. Remember, an audit clause (and the additional terms in the contract) is your discovery device. You don't want to limit this. The contract should be broad because when you perform an audit you want the vendor to produce its records to show how the funds were disbursed. In a kickback case that's extremely important since there's a good chance that the kickbacks are recorded on the books of the vendor in one form or another.

Some may argue that these terms are overreaching. However, in common law and civil law, if any person is party to a contract and in fact if there has been a conflict of interest or a kickback paid to obtain the contract, that is always a material fact. Furthermore, it's usually grounds to void the contract if the aggrieved party wants to. Therefore, a material element of the contract is certainly something that the buyer should insist on auditing.

If a buyer is considering a contract with a small business in which the total value of the contract isn't material, then the buyer doesn't necessarily want to include a cumbersome number of additional warranties in addition to an audit clause. However, in an international or high-risk contract, the buyer would certainly want to include the additional terms as well as the audit clause that would give the buyer the most discovery power.

### **Pitfall No. 9 - Failure to Conduct Regular Audits Before Fraud Occurs**

It may seem obvious, but once the right to audit clause is in place, the company must use the clause. This could mean conducting regular, limited audits on some vendors, while performing more detailed examinations on others. The selection, timing, and auditing of the vendors is critical to make the program effective.

Investigators and auditors can take advantage of inexpensive datamining software to search vendor databases for red flags indicating potential problems. ACL (available at [www.acl.com](http://www.acl.com)) is an excellent product that our firm uses (and highly recommends) that allows investigators and auditors to be proactive as well as reactive. Massive amounts of data can be cross-referenced and searched for anomalies that pinpoint fraud or areas for additional investigation. Our firm is also familiar with IDEA (available at [www.cica.ca/idea](http://www.cica.ca/idea)).

Right-to-audit clauses are a necessity in business. They greatly help control fraud and abuse in organizations by simply affording the discovery device that may only be available through expensive lawsuits.

## **SIDEBAR**

### **Specific Items to Include in a Right-to-Audit Clause**

In his book, "Outsourcing, Downsizing, and Reengineering: Internal Control Implications," Albert Marcella Jr. recommends ten specific items to be included in a right to audit clause for a construction contract.

These can be easily modified for a non-construction type contract:

1. References to specific records, such as original estimate files, change order estimate files, and detailed worksheets, subcontract, and supplier proposals for both successful and unsuccessful bidders, all project-related correspondence, subcontractor and supplier change order files (including detailed documentation covering negotiated settlements); back-charge logs and supporting documentation; any records detailing cash, trade, or volume discounts earned; and insurance proceeds, rebates, or dividends received.
2. A specific requirement for the contractor to provide the owner with copies of records in computer readable format as well as hard copy.

3. A general reference providing the right to audit any other supporting evidence necessary to substantiate charges related to the contract (both direct and indirect costs, including overhead allocations as they may apply to costs associated with the contract).
4. A general reference providing the right to audit any records necessary to permit evaluation and verification of (a) contractor compliance with contract requirements, (b) compliance with the owner's business ethics policies, and (c) compliance with the provisions for pricing change orders, payments, or claims submitted by the contractor or any of his payees.
5. A general description of the length of time the contractor's records shall be subject to audit, such as "throughout the term of his contract and for a period of three years after final payment, or longer if required by law."
6. A specific "flow-down right-of-audit provision" that requires the contractor to include the right to audit provisions in the contracts (including those of a lump sum nature) of all subcontractors, insurance agents, material suppliers, or any other business entity providing goods and services (specifically providing the right of the owner's representatives to examine their records).
7. A specific provision that allows the owner to interview any of the contractor's current and former employees during the audit.
8. A specific provision that the contractor will provide the owner with adequate and appropriate workspace, with access to photocopy machines.
9. (Optional) A specific proviso that the owner will recoup the cost of the audit if the audit detects overcharges that reach or exceed a certain percentage of the total contract billings (for example, overcharges greater than .5 percent).
10. (Optional) A specific proviso that the contractor will not only repay the owner within a specific period of time, but will also pay an additional percentage of the overcharges (for example, 1.5 times the amount of overcharge) to the owner as liquidated damages.

Source: Marcella, Jr., Albert J., COAP, CQP, CSP, CDP, CISA. *Outsourcing, Downsizing, and Reengineering: Internal Control Implications*. Institute of Internal Auditors, Altamonte Springs, Fla., copyright 1995.