How to Audit Procurement

CPE Edition

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How to Audit Procurement

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Course Information

Course Title: How to Audit Procurement

Learning Objectives:

- Recognize the manner in which the corporate budget can be used as a procurement control.
- Specify the various controls relating to the issuance of purchase orders.
- Specify the controls applying to the proper recordation of supplier information.
- Describe the different types of frauds that can arise from the procurement function.
- Recognize the different types of procurement-related investigations in which an auditor can engage.

Subject Area: Auditing

Prerequisites: None

Program Level: Overview

Program Content: A large part of the total expenditures of a business originate in the procurement department. Given the volume of cash involved, it makes sense for a business to conduct ongoing audits of every procurement activity. In the *How to Audit Procurement* course, we cover the main procurement processes, the controls applied to them, the most common forms of procurement fraud, and the different types of procurement-related investigations in which an auditor can engage.

Advance Preparation: None

Recommended CPE Credit: 1 hour

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About the Author

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been a two-time president of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books and courses:

7 Habits of Effective CEOs
7 Habits of Effective CFOs
7 Habits of Effective Controllers
Accountant Ethics [for multiple states]
Accountants' Guidebook
Accounting Changes and Error Corrections
Accounting Controls Guidebook
Accounting for Breweries
Accounting for Casinos and Gaming
Accounting for Derivatives and Hedges
Accounting for Earnings per Share
Accounting for Income Taxes
Accounting for Intangible Assets
Accounting for Inventory
Accounting for Investments
Accounting for Leases
Accounting for Managers
Accounting for Mining
Accounting for Retirement Benefits
Accounting for Stock-Based Compensation
Accounting for Vineyards and Wineries
Accounting Information Systems
Accounting Procedures Guidebook
Activity-Based Costing
Activity-Based Management
Agricultural Accounting
Auditor Independence
Behavioral Ethics
Bookkeeping Guidebook
Budgeting
Business Combinations and Consolidations
Business Insurance Fundamentals
Business Ratios
Business Strategy
Business Valuation
Capital Budgeting
CFO Guidebook
Change Management
Closing the Books
Coaching and Mentoring
Conflict Management
Constraint Management
Construction Accounting
Corporate Bankruptcy
Corporate Cash Management
Corporate Finance
Cost Accounting (college textbook)
Cost Accounting Fundamentals
Cost Management Guidebook
CPA Firm Mergers and Acquisitions
Credit & Collection Guidebook
Crowdfunding
Developing and Managing Teams
Effective Collections
Effective Employee Training
Effective Innovation
Effective Negotiation
Effective Time Management
Employee Onboarding
Enterprise Risk Management
Entertainment Industry Accounting
Ethical Frameworks in Accounting
Ethical Responsibilities
Excel Charts and Visualizations
Excel Data Analysis Tools
Excel Data Management
Excel Formulas and Functions
Fair Value Accounting
Fiduciary Accounting
Financial Analysis
Financial Forecasting and Modeling
Fixed Asset Accounting
Foreign Currency Accounting
Franchise Accounting

(continued)

Fraud Examination
Fraud Schemes
GAAP Guidebook
Governmental Accounting
Guide to Analytical Procedures
Guide to Audit Sampling
Guide to Audit Working Papers
Guide to Auditor Legal Liability
Guide to Data Analytics for Audits
Health Care Accounting
Hospitality Accounting
How to Audit Cash
How to Audit Equity
How to Audit Fixed Assets
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Optimal Accounting for Cash
Optimal Accounting for Payables
Optimal Accounting for Payroll
Partnership Accounting
Payables Management
Payroll Management
Performance Appraisals
Project Accounting
Project Management
Property Management Accounting
Public Company Accounting
Purchasing Guidebook
Real Estate Accounting
Records Management
Recruiting and Hiring
Revenue Management
Revenue Recognition
Sales and Use Tax Accounting
Succession Planning
The Balance Sheet
The Income Statement
The MBA Guidebook
The Soft Close
The Statement of Cash Flows
The Year-End Close
Treasurer's Guidebook
Unethical Behavior
Working Capital Management

On-Line Resources by Steven Bragg

Steven maintains the accountingtools.com web site, which contains continuing professional education courses, the Accounting Best Practices podcast, and thousands of articles on accounting subjects.

How to Audit Procurement

Introduction

Procurement refers to the activities required to obtain goods and services from suppliers. It is needed to ensure that purchases are made at reasonable prices and from reputable suppliers. It is particularly important for the procurement group to focus on obtaining materials and services that are in short supply, and which could interfere with the operations of the business if they are not available when needed. The procurement department strives to make purchases at the minimum total cost to the organization, which includes procurement costs, quality issues, delivery costs, and inventory storage costs, while also giving consideration to supplier reliability. In effect, the ideal outcome is when a business maximizes the quantity and quality of goods obtained, while minimizing their total cost.

In this course, we discuss the ways in which the procurement function can be audited from the perspective of the internal auditor. We begin with an overview of the procurement process and related controls, since the auditor will need to understand them in order to spot instances in which there are control breaches within the department. We then go on to address a variety of procurement fraud schemes, conflicts of interest and negligence, and a number of auditor activities worth pursuing.

Procurement Process Overview

Procurement involves four primary activities, each of which may require controls, depending on the circumstances. The activities are:

1. Procurement requisition
2. Bidding
3. Order derivation
4. Order monitoring

A narrative description of these four activities follows.

<u>1. Procurement requisition</u>

The procurement process begins with someone filling out a requisition form, in which they state what they want the procurement staff to buy. The form is in duplicate, so that the person filling out the request can retain a copy. If the company has an on-line ordering system, the person completes an on-line form, and the system sends an acknowledging e-mail. In either case, the requisition is sent to the procurement department.

<u>2. Bidding</u>

If a requisition is for a large enough amount of money, the procurement staff goes out for bid in order to obtain the best deal. If a company engages in bidding, there will likely be a bidding packet assembled that documents who was contacted, the resulting bids, and why the winner was selected.

3. Order derivation

Once a supplier has been selected, the procurement staff creates a multi-part purchase order that authorizes a purchase. One copy goes to the supplier, one is retained in the procurement department and matched to the original requisition form, and other copies go to the receiving and accounting departments. The receiving department needs to refer to the purchase order when the goods arrive, and the accounting department needs it for three-way matching. It is possible that another copy is sent to the requisitioning department, in case they want to match it with their copy of the originating requisition.

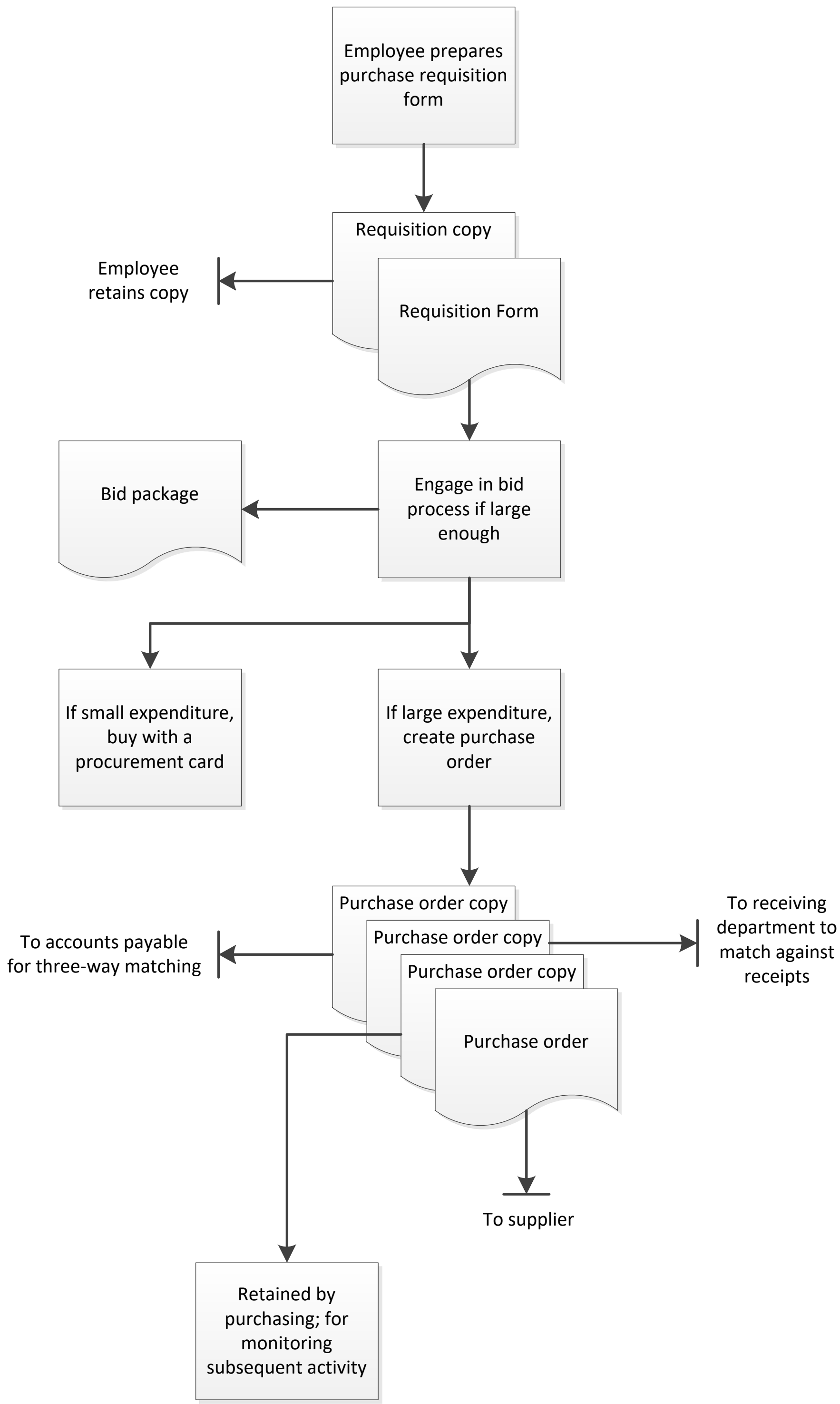
If an order is too small to warrant the use of a purchase order, the procurement staff may instead use a procurement card, which avoids a considerable amount of paperwork.

4. Order monitoring

The procurement staff monitors open purchase orders to ensure that suppliers complete them by the required due date, and then close out any residual balances on orders that have been mostly filled. The department may extend its order monitoring to a more formal rating system for suppliers, which it uses to determine its preferred list of suppliers.

The general flow of these four purchasing steps, including the associated paperwork, is noted in the following flowchart.

Procurement Process Flow



In-Process Procurement Controls

In this section, we cover the controls that can be imposed on the core procurement processes.

1. Procurement Requisition

There needs to be a properly organized system for bringing procurement requests into the procurement department. The core of this system is the procurement requisition, which is itself a control over the accuracy of information provided and the authorization to purchase something. The controls related to procurement requisitions are:

- *Require procurement requisition*. One of the larger problems in the procurement area is being inundated with procurement requests from everyone in the company who wants to buy something. Not only is this disorganized, but it also introduces a control problem where any*one* can order any*thing*. The solution is to require all requesters to fill out a procurement requisition form that identifies exactly what someone wants to buy (with complete specifications, and preferably the account to be charged). This form should be signed by the person whose department will be charged for the item being requested.
- *Use prenumbered procurement requisitions*. If procurement requisitions are to be used, prenumber the forms. The procurement staff can then track the numbers that it has processed, which may indicate that some requisitions have been lost. They can be tracked down by going to those departments to which certain ranges of document numbers were assigned, and seeing if they retained copies of the missing documents.
- *Verify against budget*. Most procurement departments simply order what they are told to buy. However, it is possible to go a step further and compare the procurement request to the remaining amount of funding available in the budget. This takes extra time, and is only useful near the end of the fiscal year, where there may be little money left in the budget. However, in budget-constrained environments, such as governmental and non-profit situations, it may be an essential control.

2. Bidding

If the size of a purchase mandates that competitive bidding be used, there need to be controls over the process to ensure that it is completed fairly. In addition, these larger purchases may involve supplier contracts, which require a review to ensure that the contract terms are reasonable. The controls are:

- *Create bidding data trail*. There should be evidence that the procurement staff engaged in bidding, thereby providing a barrier to suppliers giving kickbacks to the staff in exchange for their orders. This data trail should include a list of who was contacted, copies of their bids, and the reason why a purchase order was awarded to the winner.
- *Require legal review of contracts*. If the company is to engage in a contract with a supplier, have the legal staff review it to see if there are any shortcomings or risks to which the company may be subjected. This control usually only applies to larger contracts; otherwise, the legal department may be buried with reviews.
- *Use a contract checklist*. The legal staff should use a standard review checklist when examining proposed contracts with suppliers. This checklist is particularly important if contract reviews are handled by the procurement staff, since they have less legal knowledge. Sample review items include the expiration date of the contract, prices, discounts, delivery dates, quality specifications, payment terms, warranty terms, and termination notification provisions.

3. Order Derivation

The purchase order itself is the best control point in the procurement process, since it documents exactly what is being purchased and the terms under which the company agrees to make a purchase. It is also used in the receiving and accounting departments for additional controls. The controls related to the derivation of purchase orders are:

- *Generate purchase order*. The procurement department issues a purchase order for every purchase made above a certain minimum dollar amount. By doing so, the procurement staff is, in essence, approving all expenditures before they have been made, which may prevent some expenditures from ever occurring. This control may be strong enough to eliminate the need for a check signer.
- *Match purchase order to procurement requisition*. The purchase order should match the item requested on the procurement requisition form. To ensure this, the department's copy of the purchase order should be compared and stapled to the requisition form.
- *Obtain manager approval*. If a purchase is for a very expensive item, it may be useful to involve the procurement manager by requiring his or her signature on the purchasing authorization. This step is only going to help the control environment if the intent is to go back to the person requesting the item to make absolutely certain that they want to make the purchase.

4. Order Monitoring

An unfilled purchase order represents a future liability of the company, and so should be monitored closely. The following controls are used to ensure that this monitoring is conducted:

- *Retain a purchase order copy*. If the company does not store its purchase orders in a database, the procurement department should retain a copy of each purchase order. This is useful for monitoring open purchase orders, as well as for tracking down orders that may have been lost by suppliers.
- *Review open purchase orders*. A major control is to tightly monitor the status of open purchase orders. This involves matching purchase orders against receiving reports to ascertain which orders are overdue, and following up on them. Though this is not a control over money (as is the case with most accounting controls) it *is* a control over operations, since missing materials can shut down a business.
- *Close residual purchase orders*. The procurement staff should periodically review the list of open purchase orders to see if any have been largely filled, with just a few residual units not shipped. Depending on the circumstances, it may make sense to close these purchase orders, thereby reducing the number of open items to monitor.

Additional Procurement Controls – Fraud Related

There is a reasonable chance that fraud will occur in the procurement area, since it involves the creation of a document that is a legal authorization to buy from a supplier. If someone can gain access to a company's purchase orders, they could order goods for which the company would be liable to pay suppliers. Accordingly, consider implementing the following controls to prevent or at least detect fraud:

- *Prenumber purchase orders*. If a company prepares purchase orders by hand and uses them as the primary authorization to pay suppliers, the purchase order document itself becomes quite valuable. Someone could fraudulently use a purchase order to order goods for themselves. To avoid this issue, prenumber all purchase orders and lock them up.
- *Password-protect purchasing software*. If the company creates purchase orders on-line and uses them as the primary authorization to pay suppliers, someone accessing the purchase order database can fraudulently order goods. To prevent this, use passwords to restrict access to the purchasing software.

- *Password-protect the vendor master file*. A supplier could offer a kickback to an employee for altering the terms of payment listed in the vendor master file, or an employee could create a fake supplier and use it to pay himself. These problems can be mitigated by using passwords to restrict access to the vendor master file.
- *Review the vendor master file change log.* There are a number of ways that the vendor master file can be altered for fraudulent purposes, such as changing a payment address to that of an employee, and then changing it back. To detect these changes, review the change log on a regular basis. Change logs are usually only available in higher-end procurement software.
- *Review expense trends*. There may be an unusual blip in an expense line item in a particular month that was not caught by any of the in-process controls. Once investigated, the system can be modified to catch similar offending transactions in the future.

Additional Procurement Controls – Periodic Actions

The following controls are useful for ensuring that purchase orders are used, that they are created correctly, and that the records supporting the procurement system are properly maintained. They are not necessarily part of a specific process; instead, the procurement staff schedules them as separate tasks. These controls are:

- *Reject deliveries without a purchase order*. In every business, there is always someone who places orders without going through the procurement department. A possible control over this behavior is to require the receiving department to reject all deliveries made for which there is no authorizing purchase order.
- *Review automated orders*. In many manufacturing operations, a materials planning system automatically generates purchase orders for raw materials, based on on-hand quantities and the production plan. The procurement staff can review these automated orders before they are released, to ensure that record errors are not triggering orders for goods that the company does not really need.
- *Use a supplier naming convention*. If the procurement and accounts payable software interact, the procurement staff may be responsible for setting up records in the vendor master file for new suppliers. If so, there should be a naming convention in place that makes it less likely to create a new record for an existing supplier. This reduces the number of records in the vendor master file.
- *Consolidate the vendor master file*. In a larger business, it is entirely likely that multiple vendor files will be opened for a single supplier. This makes it difficult to assemble consolidated information for a single supplier, which is needed for spend management analysis. Consequently, the procurement staff should engage in a periodic examination of the vendor master file to see if any records can be consolidated.
- *Designate suppliers as inactive*. If a supplier has not been used for some time or has been decertified, the procurement department may want to set its status to inactive in the vendor master file. By doing so, the department will be much less likely to contact the supplier for bids or place orders with it. This is an especially important control if the company is concentrating its business with fewer suppliers in order to achieve volume discounts, and needs to stop doing business with peripheral suppliers.
- *Certify suppliers*. If a company has a quality program, it may engage in a periodic supplier certification review. This can encompass such factors as testing products against contract specifications, examining delivery dates, and visiting supplier facilities. There may also be a comparative ranking system, whereby low-scoring suppliers receive warnings and may be replaced.

Procurement Fraud Schemes

Procurement fraud involves any activity resulting in a business paying an excessive amount for goods or services. When procurement fraud is perpetrated over a long period of time, it can result in some of the largest fraud losses that an organization can experience. The procurement staff is responsible for purchasing most big-dollar items in an organization, so a fraud-minded employee in this area has the opportunity to take kickbacks from favored suppliers, or acquire goods for his or her own personal use. There are several types of procurement fraud, as noted in the following sub-sections.

Diverted Purchases Fraud

A person working in the procurement department can issue purchase orders to suppliers to deliver goods or services elsewhere and to charge the company. Since the procurement person creates an authorizing purchase order, the resulting supplier invoices are usually paid without question. The diverted purchases are intended for the personal benefit of the employee. For example, goods could be delivered directly to the employee's home. This situation works especially well when the supplier in question is also delivering goods and services to the company; in this situation, the supplier is already established with the company and so is less likely to be investigated.

This type of fraud is quite difficult to spot, especially when the resulting expenses are buried in the cost of goods sold account.

Fake Supplier Fraud

A procurement person issues purchase orders to a fake supplier and then creates fake invoices from that supplier; these invoices are usually for services, so there are no receiving documents, and they are small enough not to be flagged by company controls. The payables department does not see a problem, and issues payment to the fake company, which means that the payments are being made to the procurement person behind this arrangement.

Kickbacks

In a kickback scheme, a supplier pays a buyer a bribe in exchange for selecting the supplier to sell goods and services to the buyer's company. This results in inflated prices and/or substandard quality levels for the company. A variation on the concept is for the supplier to hire a relative of the procurement person, typically at an inflated level of compensation; by doing so, there is no traceable payment being made to the procurement person. Other variations are for the kickback recipient to take out a loan and have the loan payments paid by the supplier, or for the supplier to issue the person a credit card, with all payments on the card being made by the supplier.

Bid Rigging

A variation on the preceding kickback scheme is when a procurement employee assists a supplier in winning a competitive bid. Under a competitive bidding arrangement, a number of suppliers are asked to provide bids. The employee can assist a preferred supplier by excluding other suppliers from the bidding process, altering the terms of the bid solicitation to favor that supplier's goods and services, informing the supplier of the terms of other bids already received, and influencing the subsequent selection process to favor the indicated supplier. Another variation is to set up such a narrow time window within which to submit bids that most bidders are unable to submit bids on time, and so are rejected.

A bid rigging situation is not easily pinpointed, since the methods used may be so subtle that there is no clear indicator on an individual bid basis that anything is wrong. The situation is more obvious when a number of bids are aggregated, at which point it will become clear that a particular supplier is winning a disproportionate number of contracts.

External Procurement Fraud

Procurement fraud can also arise outside of the organization, without any employees even being involved. For example, a company issues a request for proposals, and the receiving suppliers conspire to fix prices at a higher level than would have been the case if they had competed honestly against each other. This arrangement works for the suppliers if there are payoffs to the losing suppliers, or if the low-bid amount is passed around among the suppliers over time. These arrangements are extremely difficult to spot, since they are entirely external to the organization.

Procurement Negligence

Not all issues found within the procurement function are derived from fraudulent activity. It is also quite possible that some problems are simply the result of negligence, such as conducting a slipshod review process when examining supplier bids, or issuing an incorrect purchase order, or mistakenly not obtaining management approval of a major capital asset purchase. Though no fraud is present in these situations, they can still result in losses that may rival the amounts lost through actual fraud. Consequently, the auditor needs to investigate situations of negligence just as much as fraud, and devise controls to mitigate their negative effects to the greatest extent possible.

Auditor Activities

Since the procurement function is one of the most important activities in a business, the auditor needs to have an unusually strong knowledge of how the processes function within it, as well as the details of all controls integrated into those processes. We have addressed controls in the prior sections of this course. In addition, it is helpful to have a clear understanding of the firm's procurement strategy, since it impacts how the department engages in procurement activities. For example, the strategy may state the balance being targeted for the expected frequency and size of procurement transactions. Thus, a business interested in pursuing a just-in-time materials management system will tend to buy in smaller individual quantities and mandate very frequent delivery intervals. This information is useful to the auditor, who would see a strategic mandate to buy in small quantities, and then question why larger purchases are being made. Yet another issue is a strategic mandate to source goods from environmentally-responsible suppliers, for which the auditor can investigate the level of implementation. With this knowledge of controls and procurement strategy in hand, the auditor can then pursue the following investigations:

General Investigations

- *Strategy analysis*. The auditor can determine how long it has been since company management reviewed and updated the procurement strategy (which is typically an annual event). Doing so on a regular basis is useful for having a cost-effective procurement function, and one that is closely aligned with the broader strategies of the firm.
- *Delegation of responsibility*. When the procurement function is spread out among several locations, the auditor can investigate whether authority to conduct localized purchasing transactions has been clearly stated, and also look for instances in which actual purchasing authorizations differ from what senior management has formally authorized.
- *Separation of duties*. The auditor can investigate whether there is an adequate separation of duties for each person working in the procurement department. Adequate separation of duties makes it impossible for one person to authorize a purchase, physically receive the purchased goods, and authorize payment to the supplier – which would greatly increase the risk of fraudulent activities. Procurement personnel are routinely authorized to purchase goods and services, but are not allowed near the other two functions.
- *Employee rotation*. Department employees should be rotated through a different set of suppliers on a regular basis, which prevents them from developing long-term relationships with suppliers, along

with the attendant conflicts of interest. The auditor can review whether this practice is being followed.

- *Employee sufficiency*. The auditor can investigate the workload of procurement employees, to see if they are overworked due to understaffing. When this is the case, it is more likely that they will cut corners and ignore controls, making instances of fraud more likely, or at least triggering situations in which the company is not achieving the best possible price.
- *Social responsibility compliance*. If the company has a goal of only buying from responsible suppliers, then the auditor can investigate the department's level of compliance with this goal, such as by investigating whether suppliers are employing underage workers, or are engaged in irresponsible environmental practices. In these situations, the auditor might conclude that the department is complying with management's instructions, even though doing so has increased the costs of materials.

<u>Request for Procurement Investigations</u>

- *RFP specificity*. The procurement staff will be more efficient if each request for procurement (RFP) received is fully completed, including such information as technical specifications, a required due date, and an accounting charge code. When this is not the case, the company may incur significant remediation costs at a later date (usually when the goods are received and discovered not to be in accordance with the company's needs). The auditor can investigate whether this is the case, and spotlight which individuals or departments are most lax in providing complete information to the procurement staff.
- *RFP approvals*. Every RFP should be signed by the manager whose budget will be affected by it. For larger RFPs, this may call for multiple approvals, based on the company's procurement authorization policy. The auditor can investigate whether this is the case.
- *RFP cancellation*. Once an RFP has been fulfilled, the auditor can verify whether it has been cancelled in the procurement system. An additional task is to see if any partially fulfilled RFPs need to be (or have been) cancelled. These actions are targeted at the detection of unnecessary expenditures.
- *Brand/supplier favoritism*. When a request is made to buy a specific brand or from a specific supplier, the auditor can investigate the reasons for this. Unless there is a solid, well-documented reason for doing so, it is possible that these requests will result in unwarranted additional expenditures above the market rate.
- *Unprocessed RFPs*. The auditor can see if there are any RFPs that have not been processed. This could indicate a procedural problem involving who is responsible for handling each RFP, and how these documents are recorded in the procurement system.

<u>Supplier Investigations</u>

- *Supplier registration methodology*. The department should have a standard process in place for collecting information about new and current suppliers, so that the same data are stored for all suppliers. When this is not the case, the staff will be more likely to place orders with those suppliers having more complete records. The auditor can examine a selection of supplier records to see if this is the case.
- *Supplier authorizations and deletions*. There should be a process in place for approving suppliers, which may be based on a variety of criteria, such as financial stability, quality metrics, and on-time delivery metrics. The auditor can investigate whether these criteria are being applied consistently and fairly to the approval of new suppliers, as well as to the deletions of suppliers from the company's approved supplier database.
- *Supplier performance monitoring*. The department should have a monitoring system in place that compiles a performance report card for suppliers. The auditor can investigate whether this system is operating, how performance is scored, whether the information is shared with suppliers, and how

the information is used internally to rate suppliers. The auditor can also determine whether all suppliers are ranked using the same system, or whether there is some inconsistency in the process.
- *Supplier concentration analysis*. When the department uses a very small number of suppliers for the bulk of its sourcing requirements, this can present the risk of excessive reliance on them. The auditor can calculate which suppliers are receiving the bulk of all orders, and investigate whether there are any contingency plans to cover the company in case these suppliers fail.

<u>Bidding Investigations</u>

- *Requirement revisions*. During a more complex bidding process, it is common for the procurement department to issue updates to registered suppliers regarding changes to the firm's technical requirements. The auditor can contact suppliers to see if these updates were received. If not, this is a possible indicator that the procurement staff was attempting to skew bids toward favored suppliers.
- *Supplier input*. The auditor should be watchful for situations in which a supplier is providing the procurement staff with the technical specifications for a bidding process, since this can strongly skew the outcome in favor of that supplier; after all, it is bound to meet all of its own specifications! For a more technical bidding situation, the use of supplier-provided specifications may be unavoidable, however, since the relevant expertise may not exist in-house.
- *Bid timing*. A procurement person could impose tight deadlines in order to favor certain suppliers in a bidding situation. The auditor could review the start and stop dates for a selection of bidding situations to see if this has happened, and investigate the reasons for it.
- *Document submission exceptions*. In competitive bidding arrangements, all bids must be received by a specific date, where exceptions may be allowed due to unusual circumstances, such as bids being lost in the mail. When these exceptions are present, the auditor should review the reasons for any exceptions granted, and also note whether these exceptions resulted in a purchase order being awarded to the supplier favored by this treatment.
- *Sealed bid confidentiality*. When the bidding process involves the use of sealed bids, they are typically held unopened until they are formally opened, where they are read aloud and their key terms recorded. To preserve confidentiality, unopened bids should be stored in a locked location. The auditor may observe the bid opening process for irregularities, as well as verify the security of sealed bids while they are in storage prior to their opening.
- *Allowed bid modifications*. The procurement department may allow a supplier to alter its bid for a specific reason, such as a calculation or technical specification error. If this adjustment is offered to one bidder, then it should be offered to all bidders. The auditor can review the circumstances of allowed bid modifications, and also determine whether the same alternative was offered to any other bidders.
- *Scoring analysis*. For a more complex bidding situation, such as for a software selection, there is likely to be an evaluation that includes a qualitative assessment of such factors as a supplier's commitment to customer service, the usefulness of a software user interface, and the quality of the supplier's goods and services. The auditor can conduct a comparison review of the various supplier bids to see if the differences in scoring were warranted.
- *Score weightings*. One of the easiest areas to manipulate in a competitive bidding situation is the weightings assigned to different parts of the scoring system used to evaluate supplier bids. Someone could simply adjust these factors up or down until the outcome favors a preferred supplier. The auditor can detect this issue by looking for changes in assigned weightings across similar types of bids, or by looking for changes in weightings over the course of a bidding process.
- *Economic evaluations*. An economic evaluation is conducted for all supplier bids that pass an initial technical evaluation, to determine which submissions represent the best value in relation to the price being charged. This analysis considers such factors as the initial price, ongoing maintenance fees, incremental costs that will be incurred, trade-in valuations, disposal costs, environmental costs, payment terms, and the time value of money. The auditor should verify that this evaluation

was conducted correctly, and preferably with at least two people involved in the evaluation process. In particular, the auditor should ensure that all costs attributable to a proposed purchase have been included in the analysis.

- *Management approvals*. An authorized person should review and approve the results of all bidding situations. Doing so places a (hopefully) objective person in the position of evaluating the work of the procurement staff. The auditor can verify whether each bidding process has been approved in this manner.
- *Supplier objections*. Suppliers may object to some aspect of the bidding process. The procurement staff should have a process in place for dealing with these objections. This is a prime area of investigation for the auditor, since these objections may include quite valid points regarding flaws in the department's procurement processes.
- *Documentation*. The preceding analyses will not be possible unless the procurement department fully documents every aspect of its bidding processes, so the auditor can examine the documentation to see if this is the case.

Transactional Investigations

- *Funding availability*. Before a procurement transaction begins, the responsible person should determine whether there is adequate funding available. If not, the company could have significant cash flow issues. The auditor should investigate whether this analysis is done, and also whether the procurement staff is tracking the remaining amount of funding available to each department.
- *Transactional thresholds*. The department should observe a purchasing threshold, below which purchases can be made directly, without any bidding processes. This threshold recognizes that some transactions are too small to be worth the administrative effort of engaging in bidding activities. The auditor should ensure that this threshold is observed, so that requisitions above the threshold properly employ bidding; it is all too easy for the procurement staff to ignore this threshold when they are busy or already favor a specific supplier. One item to look for in particular is any evidence that transactions have been split into smaller amounts in order to push them under the purchasing threshold. When bidding is not used for larger requisitions, the auditor should verify that these actions were approved in advance by management.
- *Pricing comparison*. When a company uses longer-term, fixed-price purchase contracts with its suppliers, this presents the risk that the company is overpaying due to a decline in market prices. The auditor can compare current market rates to these contractual rates, to see if the company is paying more than the market rate. This could result in a recommendation for the department to enter into shorter-term purchasing deals with suppliers.
- *Supplier favoritism*. It is quite possible that the procurement staff will favor some suppliers over others, perhaps due to personal relationships or simply because it is easier to buy all of a particular commodity from the same supplier. If so, the company is at risk of buying at prices higher than the market rate. The auditor can analyze purchasing transactions to see if there is any favoritism in the selection of suppliers over time, by examining bid situations to see how frequently the same suppliers are selected.
- *Optimum transaction sizing*. The auditor can investigate whether the department is achieving the optimum balance between efficiency and economies of scale by ordering in the correct unit quantities. At one extreme, if the department orders in large quantities, its administrative costs decline, but doing so increases inventory holding costs. Conversely, these holding costs can be reduced by ordering more frequently and in smaller quantities, but at an increased administrative cost.
- *Abnormally low pricing*. The company may have received unusually low prices from certain suppliers, perhaps because they have excess capacity or want to break into the market. The auditor may want to examine these transactions to see if the supplier has been using unusually low-quality goods or services in order to turn a profit at these price points.

- *Non-competitive procurements*. There may be situations in which the department obtains goods or services at non-competitive rates. Though there may be excellent reasons for doing so, the auditor should investigate these arrangements to see if they are justified.
- *Last-minute purchases*. It can be useful for the auditor to conduct a search for last-minute purchases. These purchases are indicative of problems, such as incorrect bill of material records, incorrect inventory records, flaws in procurement controls, inadequate employee training, and so forth. The reasons found for these purchases can then be investigated further, especially in regard to any additional costs incurred by the company that relate to them. In addition, the auditor can investigate how well the company's procedures for last-minute purchases were followed during these events (typically involving a reduced number of authorization approvals).
- *Supplier audits*. If the contract with a supplier allows the company to audit its fulfillment of contract terms and periodic billings, then the auditor may want to schedule such an event. This is particularly appropriate for larger and more complex contracts, or when the company is dealing with a supplier for the first time.

<u>Contractual Investigations</u>

- *Contract terms*. Many purchasing contracts take the form of the company's standard purchase order agreement, which contains a standard set of boilerplate terms that will be generally applicable to most situations. However, in cases where a purchase is more complex, the company is more likely to enter into a contract that is specifically designed for that transaction. If so, the auditor should review it to ensure that basic legal clauses are included, addressing at least the following topics:
    - The jurisdictions of the agreement
    - A description of the goods and/or services to be provided
    - The time period covered by the agreement
    - Any milestones to be reached during the performance period, and the nature of the milestones
    - The rights and obligations of each party
    - References to the company's standard terms and conditions
    - The amount, timing, and nature of payments to be made
    - The nature of any warranties or guarantees to be provided
    - Provisions for damages in the event of non-performance, quality shortfalls, cost overruns, and so forth
    - Dispute resolution procedures
- *Standard term amendments*. The standard terms and conditions used by the procurement department should be applied to most contracts, since they are intended to minimize the risks of exceptions to established practices. The auditor can review contracts in which the firm's standard terms and conditions are *not* being used, to see if these changes were appropriately authorized.
- *Contract duration*. When a contract commits the company to making purchases for an unusually extended period of time, the auditor may question the reason for committing the business to this obligation for such a long time, rather than returning to the market periodically to see if the department can obtain a better price.
- *Contract commitment*. The auditor can compare the date on which a contract was actually signed by an authorized person to the date on which activity under its terms commenced. The date of the authorized signature should always be the earlier of the two events; otherwise, the company is potentially committing itself to a contract prior to its formal approval.

Receiving Investigations

- *Receiving analysis*. The receiving staff needs to verify that the correct types and unit quantities of goods have been received, and that the received items are of an appropriate quality level. The auditor can verify that this is the case by observing receiving activities, as well as by reviewing the receiving exceptions noted by the receiving staff.
- *Receiving report review*. The receiving staff may be required to fill out a receiving report for each delivery to the receiving dock. If so, the auditor can review a selection of these reports to see if all relevant fields have been completed and exceptions noted. The auditor should also verify that someone has taken responsibility for each report by signing and dating it. It can also be useful to look for missing receiving reports, since their absence may be an indicator that a fraudulent transaction exists, where a delivery has been intercepted before it reached the receiving dock. Finally, the auditor should review whether any exceptions noted were forwarded to management for further action.
- *Services analysis*. Services being provided to the company, such as janitorial, maintenance, and painting services, are not examined by the receiving staff. In these cases, the auditor can conduct inspections of the quality of the services provided, and also investigate any complaints received in regard to services performed.

Conflicts of Interest

Another activity for the auditor to look at is conflicts of interest within the procurement department. A conflict of interest is a situation in which a person has competing interests or loyalties. For example, the auditor may find that a procurement staff person is the part-owner of a supplier, or sits on its board of directors. In these roles, he or she stands to profit from the supplier relationship, which presents the temptation of directing business toward that supplier even when doing so is not in the best interests of his or her employer. The presence of a conflict of interest does not necessarily indicate the presence of fraud, but it does make it more difficult for a procurement person to deal with a supplier on an arm's-length basis.

There are a number of ways in which a conflict of interest could arise. Consider the following:

- A supplier offers to give a procurement person tickets to the latest theater show.
- A supplier sends an expensive watch to a procurement person as a Christmas present.
- A supplier offers to employ a procurement person's daughter.

Outsourcing Issues

A business might outsource some of its procurement functions, such as locating new suppliers, researching prices, negotiating contracts, and processing purchase transactions. This is typically done to gain access to expertise that is not available in-house, as well as to reduce costs. While there are advantages to this approach, it also presents the significant risk of dealing with a third party to which work has been outsourced, possibly in a distant market. If that party engages in less than ethical activities, any problems caused by that party may be foisted upon the company. Consequently, the auditor needs to allocate significant resources to in-depth investigations of these third parties.

Summary

An auditor investigating the procurement function may very well dig too deep into this massive area, concentrating too much on individual transactions. This is an area in which the auditor needs to focus on the big picture, to decide whether the procurement department is achieving its primary aims of gaining the best value from suppliers for a good price, locating high-quality suppliers, and conducting its operations in a reputable manner. Thus, whenever an exception is found, the auditor needs to tie this event back to the primary aims of the department, to see if there is a more general concern that should be brought to the attention of management.

Review Questions

1. A bidding trail is needed to:
   a. Show that an employee found the best price before completing a procurement requisition
   b. Show that an employee was hired at the lowest possible cost
   c. Show that the procurement staff engaged in bidding
   d. Ensure that purchase orders were fulfilled by suppliers

2. It is essential to review open purchase orders:
   a. To ensure that materials are received in time for operations to run smoothly
   b. To ensure that suppliers are billing the correct prices
   c. Since they are so closely linked to sales orders
   d. Within the first week of issuance

3. An auditor is investigating the validity of economic evaluations. This is an example of a ___ investigation.
   a. Request for procurement
   b. General
   c. Contractual
   d. Bidding

Answers to Review Questions

Review Answers

1. A bidding trail is needed to:
    a. Show that an employee found the best price before completing a procurement requisition
    b. Show that an employee was hired at the lowest possible cost
    c. Show that the procurement staff engaged in bidding
    d. Ensure that purchase orders were fulfilled by suppliers

    a. Incorrect. Employees do not engage in bidding in order to complete a procurement requisition; that task is given to the procurement staff.
    b. Incorrect. Employees are typically hired at a wage that matches their skills and experience, not the lowest possible cost.
    c. **Correct. A bidding trail shows that the procurement staff engaged in bidding activities in order to obtain the best possible deal.**
    d. Incorrect. Supplier fulfillment occurs after bidding has been completed.

2. It is essential to review open purchase orders:
    a. To ensure that materials are received in time for operations to run smoothly
    b. To ensure that suppliers are billing the correct prices
    c. Since they are so closely linked to sales orders
    d. Within the first week of issuance

    a. **Correct. Open purchase orders must be reviewed to ensure that materials are received in time for operations to run smoothly. Otherwise, it is possible that a supplier is not capable of delivering ordered goods in a timely manner, and has not informed the company of this issue.**
    b. Incorrect. Reviewing a company's own purchase orders does not reveal the prices that suppliers will bill to the company.
    c. Incorrect. There is no link between sales orders and purchase orders, since sales orders come from customers and purchase orders are issued to suppliers.
    d. Incorrect. The review dates for purchase orders depends upon how soon the ordered materials are needed.

3. An auditor is investigating the validity of economic evaluations. This is an example of a ___ investigation.
    a. Request for procurement
    b. General
    c. Contractual
    d. Bidding

    a. Incorrect. A request for procurement investigation relates to such matters as the specificity of the information provided, whether the form has been approved, and whether it favors a specific brand or supplier.
    b. Incorrect. A general analysis relates to such matters as the delegation of responsibility, the separation of duties, and the rotation of supplier assignments among procurement employees.
    c. Incorrect. A contractual investigation relates to such matters as the validity of contract terms and the duration of a contract.
    d. **Correct. Economic evaluations are conducted on supplier bids, to see if they represent good value in relation to the price being charged.**

Glossary

B

Bid rigging. The fraudulent handling of a bidding process to ensure that a specific supplier wins.

C

Conflict of interest. A situation in which a person has competing interests or loyalties.

K

Kickback. An illegal commission paid to someone in exchange for preferential treatment.

P

Procurement. The activities required to obtain goods and services from suppliers.

Purchase order. A written authorization by a buyer to acquire goods or services.

S

Sealed bid. A document enclosed in a sealed envelope and which is submitted in response to an invitation to bid.

V

Vendor master file. A repository of online information about an organization's suppliers.

Index

Final Examination

The final examination for this course is provided below. Feel free to circle your choice for the best answer to each question. To enter your answers online and receive an immediate grade and completion certificate, follow these steps:

1. Go to www.accountingtools.com/cpe
2. Click on the "Access the Training Module | Complete a Test" button near the top of the page.
3. Login with your user name and password.
4. Select the **Take a Test** option and then select the **Programs** option. Click on the program that you want to take.
5. Take the test. You can stop and restart the test at any time.

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1. The budget can be a procurement control:
   a. When it controls the staffing of the procurement department
   b. Near the beginning of each budget year
   c. When purchases are matched against budgeted funding
   d. Solely in for-profit enterprises

2. Purchase orders should be pre-numbered on forms when:
   a. They are created through a computer system
   b. They are considered a secondary form of authorization
   c. There are no circumstances where pre-numbering is required
   d. They are created manually

3. A supplier naming convention is needed:
   a. To avoid duplicate supplier records
   b. To avoid multiple sales tax payments
   c. To assign different names to employees for expense report payments
   d. When the number of suppliers exceeds 100

4. One way to engage in bid rigging is to:
   a. Require that all bids be received by a certain date
   b. Require that all bids be accompanied by a detailed cost breakdown
   c. Insist on awarding a contract to the lowest bidder
   d. Alter the terms of a solicitation to favor a particular supplier

5. An example of a transactional investigation is:
   a. To review the duration of a contract
   b. To review abnormally low pricing
   c. To review the quality of services received
   d. To review the deletion of formerly-approved suppliers