

## **Purchasing Schemes White Paper – Are your Vendors who they say they are?**

Imagine you are sitting in your office and decide to review your vendors. You pull up your vendor list from your bookkeeping file and look to see how much you are spending with them. Suddenly, something catches your eye. There is a vendor on the list that you don't quite recognize with a significant amount of money your business has spent with them. You decide to look further and see that they have a PO Box address in the same city your office is in, yet you have never heard of this company. You dig a little deeper running a Google search on the PO Box address. The results stop you right in your tracks. The PO Box search came up with the name of one of your purchasing employees. You pull up your online banking account and view checks issued to this vendor. The checks are endorsed by the same employee in purchasing. You realize you have fallen victim to a purchasing scheme.

There are several different varieties of purchasing schemes. The one referenced above was a fictitious vendor scheme which is very common. Another scheme we will talk about is a "Pay and Return" scheme. We will also cover "Personal Purchase Schemes". Finally, we will conclude with ways to prevent Purchasing Fraud schemes from occurring in your business.

Another name for the Fictitious Vendor Scheme is the "Shell Company Scheme". The name is self-explanatory. An employee sets up a false business entity, or a shell company, to receive payments for themselves or others they may be working with. The false business entity has no other purpose than to receive these payments and distribute them to the fraudster(s). How does the fraudster get the false business setup? They may go as far as registering it with the Secretary of State in their home State, or in one of their accomplices States. Then, if they are working in purchasing, set up the shell company as a vendor in the bookkeeping system. The fraudster may even go so far as to create false invoices to back up the purchasing expenses. Many purchasing departments are issuing payments to false vendors without Management or Ownership being aware.

The "Pay and Return" scheme is another popular purchasing scheme used by fraudsters. What the fraudster will often do in this case is partner with a legitimate vendor that over-bills the customer (the fraudster's employer) for products or services rendered. The fraudster and the vendor split the difference or pockets the funds once the invoice is paid by the fraudster's employer. This scheme is also known as a false invoicing scheme. These schemes are often difficult to detect because the fraud is occurring with a legitimate vendor.

Finally, we have the "Personal Purchases Scheme", also known as "Expense Report Fraud". In this fraud the employee would submit an invoice or credit card expense for reimbursement of a fraudulent or personal expense. It can be for something as simple as a fuel reimbursement for running errands for the company or having to purchase office supplies. We have seen employees submit reimbursement for household groceries, and, one was even successful slipping their mortgage payment through for reimbursement. Any reimbursement should include full detailed receipts with a legitimate explanation as to why this is a business expense.

What can you and your business do to prevent purchasing fraud schemes from happening to you? The first thing we at FAI International always recommend doing is background checking your employees and vendors. This should be the first item on your internal control list. A professional background check will provide tons of useful information such as address confirmation, possible criminal/legal history and a relationship diagram. If one of your employees and one of your vendors cross paths on a relationship diagram, you may want to investigate further to see if the employee has a conflict of interest.

The next step to preventing purchasing fraud in your business is to segregate duties. This may be difficult in smaller businesses but does not mean it is not important or should not happen. I always warn businesses about “kingdom building” with employees. This is where one employee has sole responsibility for one aspect of the business and nothing can get done without that employee doing it. If you are in a “kingdom building” environment, now is the time to segregate duties between employees. Have one employee oversee purchasing, another employee in charge of payables, and another employee in charge of receivables. Rotate them between the departments every so often to prevent one employee from getting too comfortable and building a kingdom. The next employee you put in that position may uncover a fraud that you knew nothing about.

All purchases should require Management review and approval. Management should review the vendor, the product, or the services being purchased and the amounts prior to a purchase being made. This approval may slow down purchases but will save your business financially in the long run. If possible, Management should maintain a list of approved, vetted vendors. If a new vendor shows up, Management should take some time to conduct a thorough review prior to any agreements being signed or purchases being made with this vendor.

Management should implement control measures to ensure duplicate invoice and purchase order numbers are not created. Further, Management should require all expense reports include detailed receipts and explanations of why the expense is reimbursable. Mileage is another area that Management is going to want to watch closely. Submitting detailed mileage reports with an explanation why it was a business expense can go a long way to preventing fraud. We all know reports can be a pain to fill out and keep track of. Management needs to review the reports to confirm the mileage is legitimate and fits a legitimate business purpose. Same goes for expenses.

If you are too busy or have built in excuses for not review purchases and expenses, your business is going to be a victim of fraud. Preventing fraud requires active participation by Management and active measures to ensure it does not happen to your business. Internal Controls must be implemented and followed by all employees, including Management.