

**THE IMPORTANCE OF AUDITING IN AN ANTI-FRAUD WORLD
DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

When allegations of waste, fraud, overbilling, or kickbacks by a vendor emerge, the first response might be to conduct a vendor audit. The guidelines for the audit and vendor obligations are usually buried in an often overlooked section of the contract, the right to audit clause. This session will cover the value of properly crafted audit clauses, gauge the difficulty of an impending audit based on the strength of the audit clause language, discuss the audit challenges for service, and review examples of good and bad audit clause language.

**RYAN C. HUBBS, CFE, CIA, CCSA, PHR
Senior Staff Internal Auditor/Investigator
Entergy
Houston, TX**

Ryan Hubbs is a senior staff internal auditor and investigator for Entergy in New Orleans, LA. His responsibilities include conducting internal investigations and investigative audits for Entergy on a myriad of issues, including employee expense fraud, contractor fraud, conflicts of interest, ethics violations, and communication systems abuse, to name a few. Mr. Hubbs has researched and worked extensively on the design and implementation of Entergy's Fraud Risk Assessment program. Ryan conducts internal controls and fraud training for all new supervisors at Entergy.

Mr. Hubbs is also the current chapter president of the New Orleans ACFE chapter. Post Hurricane Katrina, Mr. Hubbs identified the need for a local ACFE chapter in the New Orleans area. After working with the national ACFE headquarters, the New Orleans chapter was able to be re-established in the fall of 2007.

Mr. Hubbs also has experience as an educator and presenter. He has worked as an online faculty member with the University of Phoenix, teaching the graduate-level course, Managing the Business Enterprise. He currently supports professional organizations such as the ACFE, the IIA, and local universities by giving presentations on fraud, waste, and abuse. Some of the presentations include: Conducting Facilitated Fraud Risk Assessments, Detecting and Preventing Employee Expense Purchase Schemes, How to Lose Your Job, Understanding and Combating Occupational Fraud and Abuse, Conducting Fraud Investigations, and Ethics. Mr. Hubbs has been selected as a presenter at the ACFE National Fraud Conference for the last two years.

In addition to his career at Entergy, Mr. Hubbs volunteers his time to the St. Tammany Parish Sheriff's Office in the special operations division. He holds the rank of reserve corporal and detective, and assists the property crimes division on white-collar fraud cases. His duties also include search and rescue operations, as well as routine water patrols. He also spent considerable time conducting search and rescue operations post Hurricane Katrina.

Mr. Hubbs graduated from Louisiana State University with a bachelor of science in business administration and a minor in sociology/criminology. He later graduated from Louisiana State University with a master's in business administration. Mr. Hubbs' law enforcement training includes graduation from the EBRSO Reserve Training Academy and the Texas Basic Police Officer's Academy. He is a Certified Fraud Examiner (CFE), Certified Internal Auditor (CIA), Certified Human Resources Professional (PHR), and has a Certification in Control Self-Assessment (CCSA).

"Association of Certified Fraud Examiners," "Certified Fraud Examiner," "CFE," "ACFE," and the ACFE Logo are trademarks owned by the Association of Certified Fraud Examiners, Inc. The contents of this paper may not be transmitted, re-published, modified, reproduced, distributed, copied, or sold without the prior consent of the author.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

The Audit Clause

Contract auditing mistake #1: Not all audit clauses are created equal. And just because you have a few sentences in the section entitled “Right to Audit” doesn’t mean that your upcoming vendor audit is going to be a walk in the park. The following items and considerations should be fully explored, incorporated, and/or vetted for each contract and audit clause before contract issuance.

Boilerplate or Dynamic Audit Clause Process

What does the perfect audit clause language look like?

The problem with that question is that everyone thinks they have it, but you’d be hard pressed to find two exactly alike. This disparity in audit clause language and understanding across organizations and services can actually help derail any future audits, or make vendor audits become so entangled that it might seem cheaper to just accept any fraud, waste, and abuse than to actually conduct an audit. Unscrupulous vendors also don’t always sit still and comply when they think they are going to be audited. They might actively try and use the contracts terms and gray areas to their advantage. The auditor or investigator’s advantage might come from the flexibility and specificity of dynamic audit clause formation versus boilerplate audit clause inclusion at the point of contract development.

- Boilerplate contract language was designed by attorneys and procurement professionals to help set standard contract terms while speeding up the contracting process for procurement personnel. The problem is that auditing and investigating fraud, waste, and abuse is a dynamic process and very rarely standard. Yet for many organizations, the boilerplate audit clause language is attached to every contract, indiscriminate of the goods or services being delivered. Take, for example, a

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

concrete supplier and fabricator who has two contracts with a large IT infrastructure company. The first contract is for \$15,000 for overlaying a parking lot. The second contract is for \$10 million of hardened concrete and steel as part of a disaster recovery facility. These two contracts, while both involve concrete, are worlds apart when it comes to the services, dollar amounts, risk, and potential liabilities. And because they are different and have their own unique challenges and expectations, an average boilerplate audit clause included in the larger contract could severely derail certain audit initiatives if the facility were to balloon in cost to \$20 million or leak like a civ during the lightest of downpours.

- What does it mean to have a dynamic audit clause? The term *dynamic audit clause* really applies more to the process of designing each audit clause based on the various conditions of the contract. These contract conditions can include contract type, contract amount, geographical variables, time constraint variables, the ability of inferior substitute materials, the percentage involvement of subcontractors, etc. The inclusion or exclusion of these types of conditions in the contract could undoubtedly affect type of audit clause rights and language that the organization might want to exercise at a later date. This does not mean that every audit clause in every contract has to be built from the ground up, every time. This would be cost prohibitive, and the world could come to a grinding halt. The dynamic nature allows the proper internal personnel (internal audit, compliance, investigations, etc.) to take boilerplate audit clause language and evaluate the audit clause against the draft contract terms. In doing so, the anti-fraud

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

expert can adjust the audit clause based on the following, regarding the draft contract terms and conditions:

- Where could fraud, waste, and abuse occur in this contract given the contract variables and conditions?
- What additional documentation and expectations would we have of the vendor?
- Where could they employ delay or confusion tactics and resist or cloud the audit?
- Does our current language cover all of our concerns?
- What improvements can we make or add to the audit clause language to strengthen our rights?

Defining the Audit Clause Terms—Audit, Inspect, Examine, Review, and Analyze

Why do contracts have a definitions or terms section? Your definition of a word might be completely different than the vendor's. And isn't the contract supposed to standardize the agreements and expectations of the involved parties? The audit clause is such an important piece of the contract language, it is surprising that many audit clause stipulations and expectations are not properly defined in the contract. This leaves an enormous amount of room for both parties to define words and terms that benefit them. For example, take the words *audit*, *inspect*, *examine*, *review*, and *analyze* and see how they are similar and different. Each of these can be, and sometimes are, used interchangeably in audit clause language. But, they might not convey the same meanings or expectations. Compare the definitions taken from *Merriam-Webster Dictionary*.

- *Audit*: a formal examination of an organization's or individual's accounts or financial situation

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

- *Inspect*: to view closely in critical appraisal; look over
- *Examine*: to inspect closely
- *Review*: a general survey (as of the events of a period)
- *Analyze*: to study or determine the nature and relationship of the parts of by analysis

It might sound juvenile that word games would be played during the onset of an audit, but it isn't as farfetched as you might think. A vendor who doesn't want anything to do with an audit, for whatever reason, might first start pushing back by using the actual audit clause language, or lack thereof. What does it mean to audit? Even in the accounting and internal auditing professions, the definition of what an audit is and the steps performed are not entirely the same.

This also relates to other expectations and assumptions in the remainder of the audit clause. What is *extrapolation*, and how will it be performed? What does *adequate access* mean? What are *electronic records*? This is a perfect example of where confusion can occur. The vendor scans all of their documentation on a cheap scanner, rendering all of the support documentation relatively useless. All documents are in PDFs, which is an electronic format. The vendor has upheld their side of the audit clause, but the audit team doesn't have anything to work with. Don't assume that the vendor will know, or agree to, audit terms when the actual audit day arrives.

Financial or Compliance Audit, or Both

Nothing could be worse than showing up to do a financial audit, and the only records that are available are a few policies and procedures and a list of

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

employees available for interview. How could this happen, you might say? Because compliance audit clause language was accidentally included instead of financial audit clause language. For some organizations and industries, there might be a stark difference in the types of records required and the way financial audits and compliance audits are carried out. In some instances, an organization might expect to be able to perform both. But, what records and information that will be available will depend greatly on the expectations documented in the audit clause language.

For financial audits, the list of required documentation could include dozens and dozens of potential record types. Compliance related audits, on the other hand, might require the review of non-financial information and, in some circumstances, include the interviewing of the vendor's employees and possibly their subcontractors. It might also require the surveillance of the vendor's processes when quality concerns are raised.

It is important that the proper audit clause language be included to fit the nature and scope of any potential future audits. If not properly thought out, the audit staff might be limited by what they are able to review, simply because of poor audit clause language.

Planned or Surprise

It might be difficult to think ahead at contract issuance to envision how and when an audit clause might need to be executed in the future. Some audit clauses might stipulate that the vendor will be notified in advance of any upcoming audit. Other clauses might completely leave out language that defines any notification for audit, which will default to assumptions on both parties.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

And others might document up front that no audit notification or surprise audits are needed before coming on site. It is important to understand how the inclusion or exclusion of audit notification language can affect the audit process and, in some instances, might give the vendor time to conceal, destroy, or fabricate supporting documentation.

- **Planned**—Putting audit clause language that stipulates a period of time between notification and the onsite audit might be necessary. Your organization might need a ramp-up or have travel time, the vendor might not be available, and a two-week notice might simply be inserted in an effort to keep up good vendor relations. For the majority of vendors who value the business that they are getting from your organization, this might not be an issue. But fast-forward to concerns that the vendor is falsifying invoices, engaged in bribery or kickbacks, or any other vendor issue that could come through your ethics hotline. How does a two-week heads up for the vendor affect the vendor audit now? One of the tenants of fraud investigation is to keep the proposed suspect in the dark as long as possible. The sooner they know they are being investigated, the sooner they might resort to fabricating or destroying documentation and getting their stories straight. Vendor audit strategy might have to be planned very carefully if the purpose of the audit involves suspicions of fraud and the audit clause language requires a significant heads up for the vendor.
- **Surprise**—Surprise audits can be one of the best audit tools to identify and assess what is really occurring in a process. There is no time to prepare employees, documentation exists as it normally does, and there is little time to fabricate, destroy, or

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

conceal the “undesirables.” Unfortunately, just like we wouldn’t want someone coming to our home unannounced before we could clean up, neither does a vendor. There might be significant pushback at contract issuance to any ability of the organization to conduct a surprise audit. This is where the power of the organization in influencing the contract language should not waiver or cave in to the vendor’s complaints. If past experiences have shown significant problems with vendors, then language allowing surprise audits should be insisted upon or required. If the vendor wants the business bad enough, they might not have any other option than to comply. The ability to conduct surprise audits can be a powerful compliance tool, but only if they are used. If the capability for surprise audits is included in the audit clause language, then they must be performed. The vendor not only sees that the organization is willing to exercise the audit clause language, but that they might not have the opportunity to deviate in services or falsify billings because the risk of a surprise audit is just too great. *“Increase the perception of detection, and you can decrease the possibility that fraud may occur.”*

Dual Agreement on the Independent Auditor or Firm

In an effort to appease larger vendors, some organizations might decide to include in the audit clause language that both parties must agree on any third party auditors (or investigators). While legal, procurement, and management personnel might not see this as an issue at the contract issuance phase, let’s fast-forward to when an audit or investigation is required due to allegations of overbilling or fraud. You determine that due to the size, amount of spending, and other possible issues, that you want to bring in an

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

expert recovery firm, but the vendor opposes this firm and decides to argue over which firm is “truly independent.” Again, this delay tactic moves from an audit to a legal issue where attorneys decide the fate of the audit process. Having language such as this can also complicate surprise audits of the vendor and give early warning. Dual agreement might also require that, at a minimum, the scope and concerns be relayed to the vendor so they can choose the best third party, non-biased auditor. Surprise is critical in uncovering fraud, waste, and abuse. Having a dual agreement clause in the audit clause could effectively give the vendor weeks, if not months, to prepare for the audit.

Audit Process and Methodology Agreed to by Both Parties

If there is one thing that you do not want a vendor to be involved in, it is the decision making process on how the audit will be performed and completed. Yet, these types of audit clause exceptions can find their way into the contracting process and might not be re-discovered until allegations of impropriety are made. Just as criminals aren't consulted on the investigation strategies being employed to put them behind bars, vendors should not be consulted on how an audit will be performed.

There might be a need to reference that certain Institute of Internal Audit, Yellow Book, and/or GAAP auditing standards will be adhered to during the audit. But, the vendor should not have a say on determining the sample size, confidence intervals, audit steps, etc. Looking at an agreement from an unscrupulous vendor's point of view gives the vendor a big opportunity to direct the audit away from potentially sensitive or fraudulent areas. However, even if the

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

vendor does not have the ability to affect the audit process, it is very important that an appropriate audit process and methodology does exist. If it doesn't, you can be sure that any audit findings will be challenged at the conclusion of the audit.

Time and Place Agreed upon by Both Parties

Twenty-first century vendor audits are not like 17th century duels. Just because you tell the vendor to meet you behind the monastery at daybreak with their records in hand doesn't mean that they are going to show. This language, similar to other examples previously mentioned, further complicates the vendor audit process and actually empowers the vendor. Rest assured, a vendor who has this language in their contract can prolong and inhibit the audit process by choosing or not choosing days to accommodate the audit staff. The ability to announce last-minute delays and cancellations puts the vendor in the driver seat. It is important to remember that the vendor serves at the request of the hiring organization. Language that weakens the hiring organization and empowers the vendor should be discouraged. This type of language also gives a fraudulent vendor the ability to buy time and postpone the audit so that documents can be destroyed, fabricated, or altered. Excuses might be as simple as, *"My accounting clerk who processes the invoices just had surgery, and she won't be back for six weeks."* More elaborate rouses include, *"We are currently being audited by another company, or the government, and that audit will not be completed until the third quarter."*

Specifically detailing the time and place of the audit engagement in the audit clause language might leave

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

less wiggle room and posturing by an uncooperative vendor. For example:

- Within three days of audit notification, the vendor shall respond with an appropriate start date for the audit that will not exceed two weeks from initial audit notification. The audit will be conducted at the vendor's office, where the majority of the records are housed. The vendor will make all documents (see above) available for the audit during the hours of 8:00 a.m. to 5:00 p.m., Monday through Friday, so long as these hours occur during the vendor's formal and communicated hours of operation. If the vendor does not have formal or communicated hours of operation, the vendor will adhere to previously mentioned schedule. If the previously mentioned schedule significantly interferes with the vendor's operations, the vendor must respond in writing and offer an alternative 40 hours of availability per standard week.

As mentioned previously in "Planned or Surprise," understand the pros and cons of specific advanced notification v. the ability to conduct surprise audits. What might be good for one contract might not be good for another.

On Your Own or Assistance Available

Onsite vendor audits are rarely pleasant. You are at another place of business, rooting through their paperwork, and everyone knows that a possible outcome of your presence could be a finding where they have to pony up a significant amount of money. So, don't be surprised if an unethical vendor isn't standing by to answer your every question and concern. One big logistical item that can be overlooked is whether your auditors are to simply review and copy

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

documents, or whether there will be a need to have discussions, ask clarifying questions, or possibly request additional information while onsite at the vendor's location. Depending on the nature, scope, and sheer size of the audit, it might be difficult to be onsite and not have a liaison designated by the vendor who can assist the audit staff. There might be questions about personnel, data, systems, invoice dates, procedures, starting times, sub-contractors, equipment, etc. All of this information could be vital to completing the audit. If the expectation or right is not expressed in the contract, audit staff could find themselves getting the cold shoulder when they start asking for assistance. Audit staff might also find themselves in a position where there is literally no one available to answer their questions or assist in the pulling of additional information that wasn't staged or requested prior to the audit starting.

This problem could be minimized if an assistance clause is properly added in the audit clause language. An example could be, *"The vendor shall make available a responsible party with the authority and ability to respond to audit questions, assist in document interpretation, and authorize requests for information."*

Audit Period

One of the most important rights asserted under the audit clause is the amount of time that an owner can go back and audit the billings. Many boilerplate audit clauses may default to a fixed period of time of one to three years. But, there might be more at play than an arbitrary time period picked by a procurement specialist. Here are some issues that could impact the viability of the audit, as well as implications for the organization.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

- Unlimited hold time—In some instances, audit clauses might not have a time requirement on how long records will be maintained for review. The audit clause might simply state, “*The vendor shall keep records available for review,*” or “*Records shall be maintained throughout the course of the agreement.*” In some cases, the requirement for the records to be maintained might not even be mentioned, only that they be made available. There are a few potential problems with failing to spell out the audit review period. The first is vendor burden. Depending on the complexity of the contract and the sheer amount of data that they are expected to maintain, a loosely communicated infinite hold period might be viewed as being overly burdensome. You might have an expectation that they are keeping everything, but they are keeping just enough. If cornered, they can assert the failure of the contract to dictate a definitive hold time, and/or that there were significant costs that they were incurring by keeping the data and for which they were not being compensated for.

A second issue is records retention requirements. A poorly defined audit period could put the vendor audit in a position where most of the records were destroyed according to the vendor’s records retention destruction program. This issue can become compounded when the vendor’s records retention program identifies only keeping supporting documentation for a very short period of time, say six months or so.

If viability of the records is a concern with a particular vendor, having a definitive and overriding retention clause might be valuable. As an example,

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

“All records and supporting documentation shall be kept for a period of three years. If the vendor’s record retention program calls for supporting documentation to be destroyed earlier than three years, the vendor shall amend the retention period or flag records pertaining to this agreement and properly maintain them for three years.”

- Legal statutes and implications—For some contracts, the nature of the good, service, funding, or public use of the item could bring the organization and its vendors under the purview of various local, state, federal, or international regulations. Some of these regulatory requirements might have document preservation requirements that far exceed a one to three year retention requirement. Including a lesser retention/audit time period in the contract could open the organization to fines, penalties, and/or legal action if documents are requested from them and their vendors and those documents end up being unavailable.
- Shorter than the primary service period—Unfortunately, some engagements and service periods do not fit neatly into the one to three year increments. For example, consider the expansion of a major airport. Construction costs might exceed several hundreds of millions of dollars, and the construction time might exceed five to seven years. If a one-year audit clause period is included in the primary contract, the airport has essentially given up a large majority of its auditing rights, unless it routinely conducts audits of all of the vendors every year during the course of the construction. Typically what will happen is that the vendors will not be audited until allegations arise or construction costs and delays increase significantly. In this scenario, a

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

one-year time limit might not be long enough for the airport to fully investigate their concerns.

It is important for the organization to have the ability to audit the billings and the services rendered. In our previous example, a couple of compensating items could be put in place to preserve the right to audit, but also placing more emphasis on the higher risk areas. A stratified audit period table could be designed to assign audit time periods to vendors based on estimated contract spending. Vendors accounting for the lowest level of cost might have one-year audit clause retention periods included, while the largest spending vendors might have audit clause retention periods that cover the full engagement. Regardless of the strategy or methodology, an arbitrary audit period might look good on paper, but for certain contracts, might not fully protect the rights of the hiring organization.

- Less than, more than—Some audit clauses might use the “less than, more than” language when referring to audit periods and document retention. While in some situations this type of language might appear necessary, it can become a point of confusion and disagreement. Some examples include, *“The books and records shall be kept no less than three years,”* or *“The books and records shall not be kept longer than required by law.”*

Audit clause language, where possible, should be specific and to the point. The less wiggle room there is for interpretation or gray areas, the better position the organization will be in when their audit rights are executed. If the vendor should keep the records for three years, stipulate three years. If they need to

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

be kept for five years, stipulate five years. The *longer than required by law* reference also gives the appearance of transferring regulatory retention risk to the vendor. A better practice would be for the organization to specifically communicate any particular regulatory retention requirements associated with the goods, services, or contracts in the contract or audit clause section. This might help alleviate the vendor response, “*We didn’t know we were supposed to be keeping that information, we aren’t attorneys.*”

Paper or Plastic?

This element could doom an audit before the vendor notification letter is even sent. Are supporting records kept in paper or plastic (digital media) format? A paper based audit can be extremely time consuming and costly. This should be an important consideration when not only selecting the vendor, but determining if the audit will be performed in-house or outsourced. Unscrupulous vendors know that it is much more difficult to identify errors and discrepancies if auditors have to thumb through boxes and boxes of records, and a significantly large paper-based audit might deter an audit altogether. There also needs to be an equal consideration of what electronic media really means. We all assume that if a contract states that “*supporting documentation will be kept in accessible electronic format,*” that everyone is on the same page. What does this mean? There is a huge difference between having payroll data in Excel or .CSV format versus having 10,000 poorly scanned PDFs. Both are in electronic format, but the latter might be overly time consuming or inadequate for the audit. This very generic statement of *electronic format* can give a very false sense of security. Homegrown accounting systems, old, outdated

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

storage media, and vendor payment programs that no one knows how to use could just be the tip of the iceberg when conducting a vendor audit. The vendor can claim that they upheld their end of the contract that data is kept in electronic format. Unfortunately, nothing in the contract stipulated that it had to be easily downloaded and viewable. Some data systems were designed to only allow exports by the firms who designed the programs. Annual maintenance payments to these service vendors have ceased, and support is non-existent. All the vendor knows is that it can run some canned reports, but full access to all of its data is not possible. Some vendors might even charge the organization for *developing* specialized queries to get the data out of their own systems or saddle the organization with the data export costs. A vendor audit at this stage becomes a legal standoff, as both sides begin to argue over the contract terms instead of actually conducting the audit at hand.

- A point of note is a being aware of vendors who should have adequate electronic records, but opt to only have paper records upon request. This approach can serve two purposes for the fraudulent vendor. First, paper records allow them to overwhelm the audit staff and hide possible discrepancies. Second, paper records can be recreated to say what the vendor wants them to say.

Invoice Review and Payment Is the Same as an Audit?

One of the core items of the audit clause right is that management reserves the right to review terms and conditions against any billings to identify discrepancies. Some contracts even spell this out. But, in the terms of the audit clause, who is management? Is it the frontline supervisor, the regional manager, or the internal audit department? This is a very important distinction that

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

must be made and communicated internally.

Organizations can find themselves in sticky situations when a diligent frontline department routinely refers to their review of the invoices as an *audit*, or worst yet, as exercising the audit rights of the contract. This can complicate matters when internal audit is called upon at a later date to audit the billings, only to be told by the vendor that they were already audited, and have a nice day. If routine payment and review of billings, you might also find the vendor taking the stance, *“Management already reviewed, approved, and audited my billings. If there was something wrong, they would have caught it.”* Language that attempts to couch frontline management review as an audit or field review constitutes final discussion on the accuracy of the invoices should be discouraged, and additional compensating contract language should be considered that includes:

- “Field review, approval, and payment cannot legitimize obvious errors or omissions in billings or invoices. Such discrepancies, if identified, whether after payment or during an audit, will be held to the contract terms and expectations as they are written or understood.”

Limited Time to Review Invoices

Limited time to review statements can be an attempt by vendors to circumvent the audit clause process, or at least give themselves an out if ever audited. This contract language typically states, *“The owner has 15 days to review and dispute any charges or items on the invoice. After such time, the invoice is considered accurate and approved.”* For those who have conducted a number of vendor audits, this might be one of the first fallback positions when a vendor is confronted with a billing issue or a request to audit.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

Their response to an audit notification might be, “*Per the contract, you had 15 days to identify any discrepancies in the billings and to “audit” them. Because your request is greater than 15 days, we decline your ability to audit the identified invoices.*” If this is how your audit starts, you are in for a ride. The vendor challenges your audit rights at this point by deflecting to a time constraint and that invoices defaulted to *accurate* and *approved* once the time was up. This might be the first hurdle you have to overcome without involving legal counsel and filing suit. It’s important that statements referring to timely review and payment stick to just that, review and payment. It should be made clear that review and payment does not forgo audit rights or limit recovery for billings and errors that are contrary to the nature and spirit of the contract terms.

Access, but No Utilities

What does *shall have adequate access to records and supporting documentation* really mean? This phrase is used quite frequently in standard audit clause language, but might not go far enough in ensuring that the audit staff can actually do the audit. Be careful what you ask for. Organizations simply specifying *access to records* might find their auditors sifting through boxes in a U-Store-It building with no air conditioning and limited lighting. *Adequate access to records* might be a slight improvement, but that could be argued as well.

Understand that a vendor who has committed fraud doesn’t want you to find it and will most likely try to make your stay an unpleasant one. Don’t assume that electricity, lighting, water, restroom facilities, or even Internet access will be available.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

Review v. Copy

Most audit clauses will stipulate in some manner that *records shall be available for review and audit*. But, does *review or audit* also mean *copy* by default? Don't bet on it. One of the easiest ways for a vendor to put a crimp in your audit plan is to provide 20 boxes of records, but tell you that you cannot use their copier and aren't allowed to plug in your copier/scanner or computers into their outlets. Some vendors who think ahead or have been down the vendor audit process before might actually include rates for copy machine use or per-page copying done onsite. In some instances, these fees can *pay* for any overbillings that the audit might identify. For those vendors where there is an expectation for a lot of paper-based supporting documentation, it might particularly be worthwhile to include a *copy clause* within the audit clause language, or within the contract itself, that stipulates copier and outlet use during an audit, and in some instances, might even specify a reasonable per-page copy fee up front.

Suitable Workplace or Standing Room Only?

You are sitting at a tiny table in the storage room and have the aroma of toilet bowl cleaner wafting about your face because it's six inches from your head on the shelf behind you that your back keeps hitting, when you stand up and you ask yourself, "*How did I end up here?*" The answer? An adequate facilities clause was not included in the audit clause language when the contract was drafted. Another very important audit consideration is the availability of adequate lighting, chairs, and space needed to conduct the audit. It's an old vendor audit trick; make the auditors so uncomfortable that they shorten their review and leave early. Broom closets are the location of choice, followed by storage rooms, offices with no furniture,

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

and U-Store-It storage facilities. Not exactly the place you want to be when trying to unravel a billing scheme or substitute materials fraud scheme. Nonetheless, some irate vendors might even argue the point that the audit clause simply states that you were to be given access to the records and nothing else was mentioned about desks, chairs, or the ability to use the restroom.

An adequate facilities clause can go a long way to ensure that the audit staff can perform their assigned duties in a reasonable and professional manner. As an example, *“Audit staff shall be granted access to adequate facilities in order to conduct the audit, including an air-conditioned and well-lit room with tables, chairs, electricity, and access to restroom facilities.”*

Confidentiality and Trade Secrets

There is a very good chance that nearly every vendor audit will include the review, copying, or analysis of information that could be considered confidential or an actual trade secret. Employee personnel files, payroll data, safety training records, etc., could all be deemed confidential and otherwise off limits for the purpose of the audit. Unfortunately, these might be the very records that are needed to identify falsified employees or overbilling fraud schemes. At best, the audit staff might be relegated to accepting or reviewing partial records while onsite when this defense is raised. Worst case, the vendor brings in an attorney who blesses all of the records as being confidential, thus shutting down the audit completely. It is important to plan ahead for confidentiality concerns, whether they are legitimate or used as a delay tactic.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

Whether the claim of confidentiality is for a legitimate concern or used as a delay tactic, the audit clause language should specify how confidentiality or trade secret concerns will be addressed. Confidentiality concerns could be addressed by including, “*Any records that support the billings shall be available for audit, and if necessary, confidentiality agreements will be signed prior to the audit commencing. Claims of confidentiality or trade secrets shall not prevent the company from auditing records and supporting documentation.*”

One-for-One or Extrapolation Cost Recovery

Your vendor audit gets off the ground and you realize that you have 11,413 invoices totaling \$31,538,825.17, with 150 feet of supporting documentation. You decide to take an audit sample of 150 invoices totaling \$671,894.73 in spending. Halfway through your sample, you realize that one in four invoices has issues, and the total dollar recovery of the sample might be \$174,992.12, or an error rate of roughly 26.04 percent. Your audit manager screams in glee because if extrapolated, that would mean approximately \$8.2 million in potential recovery! Whoa now, let’s slow down, forget about promotions and a huge raise, and start over at the beginning. What does the audit clause say?

One of the first steps of most vendor audits is to determine if every invoice will be reviewed, or if a sample will be taken due to the large number of transactions. Time constraints and manpower can largely dictate the method used. Consider the previous example. Many audit groups would be hard pressed to conduct a one-for-one audit of all 11,413 invoices. Without proper error identification language, the

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

vendor might actually end up benefiting from the audit staff's inability to look at everything.

For many contracts, there might be absolutely no reference to how billing errors are identified and quantified. For the vendor who either intentionally overbilled or knows that their billing process is a joke, their fallback response to audit issues might be that they will only reimburse for identified errors or overbillings. Audit clause language could actually strengthen the vendor's stance. As an example, "*Any identified billing errors or discrepancies identified during the audit will be resolved by reimbursement by the vendor or payment by the company.*" Again, in our previous example, the vendor agrees to the roughly \$175,000 in overbillings, but disagrees on any other *guessed or suspected* overbillings because they were not specifically identified during the audit, and he points at the language above.

If you know that your organization has resource constraints for conducting vendor audits and that sampling might be your method of choice, then there should be considerable thought in having extrapolation language included in audit clause language. This will allow vendor audits to be conducted off of samples without losing the ability for a much larger recovery of billing issues.

Repayment Stipulations

You just completed the audit and get agreement from the vendor that they owe \$500,000. Now, how do they reimburse the company? Are they allowed to apply the monies owed against any new requests for services?

Are they allowed to pay the amount back over the next

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

five years? Is payment due now? There are obviously pros and cons to the repayment stipulations.

- Apply to new invoices—The easiest choice, especially if there is agreement to continue using the vendor, is to allow them to apply the balance owed against new invoices. There could be several issues that this arrangement could cause.
 - In a poorly controlled accounting system, the \$500,000 might not be tracked as a receivable. As time goes by, people might forget about the audit and the monies owed. It might also have financial statement implications.
 - POs might not actually be issued, and the vendor is asked to deliver services directly by crediting the amount held on account.
 - The billing errors might be for services rendered on capital projects or for projects that have regulatory interest or oversight. Failing to reapply any overage back to these projects could affect the value of assets or monies due investors, etc.
- Long-term repayment—The vendor tells you that they just don't have the money, but can pay \$10,000/month for the next 4.5 years. There are several problems with this scenario.
 - What are the odds that the vendor will continue in business for 4.5 years? Second, if you are still doing considerable business with them, the 4.5-year excuse could be simply that, an excuse.
 - Time value of money—Allowing a simple repayment over such a long time actually reduces the amount of recovery. The organization is essentially financing a loan to the vendor at zero percent interest. If the amount is significant enough, an interest penalty should be negotiated on the repayment.

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

- Keeping track might be difficult. A reoccurring accounts receivable might have to be set up, so someone will have to keep track. And what happens if they miss a payment? Now you become a bill collector on top of everything else.
- Immediate payment—Pay up now! Or within some very short period of time. This might be the best option, and allows the organization to recover and apply the funds back to appropriate projects. It also allows for the audit to actually conclude (i.e., audit issues identified and recovery obtained). Everyone can go on their merry way. But, some vendors might not be able to agree with this approach. Some vendors might have significant cash flow issues with writing a \$500,000 check for errors identified over a three-year period. The best approach is to have the strongest repayment terms in the audit clause, which allows the organization flexibility in negotiations. Having weaker or no repayment terms might give the vendor the ability to set the repayment method and time period.
- Holding or applying to current invoices—Another repayment method is the ability to hold current vendor payments to offset any overbillings. Essentially, this is leverage for the organization. In our previous example, \$500,000 is identified and owed, and there is \$834,000 of vendor invoices ready to be processed. The organization uses the leverage repayment clause and holds back \$500,000. The difficulty of this option is the leverage that the vendor could hold in the supply of their good or service. Using this option could cause the vendor to hold merchandise, file liens, or pull out of providing services all together. The entire vendor relationship, along with the egregiousness of

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

the audit findings, should be carefully considered before utilizing this option.

NOTES

Actions and Penalties for Records Failed to be Maintained

The audit clause was clear; the vendor was to maintain accurate books and records. Well, surprise, they didn't. What now? Maybe they destroyed some records or were complacent in their responsibilities. Either way, the ability of the audit team to verify and confirm certain billings, costs, or others items has been limited. All might not be lost if proper language has been included in the audit clause that penalizes the vendor for failing to keep proper records or that reduces the ability of the vendor to argue any of the audit's findings. For example, *"If any necessary and supporting documentation is not properly maintained and available for review, or was lost or prematurely destroyed, estimated billing errors and/or extrapolation shall be the fallback quantification method with the burden of proof residing with the vendor to supply documentation to the contrary."* If you are lucky enough to have this language included in the audit clause, it might serve two purposes. First, the vendor might now have an extra added incentive, whether they like it or not, to actually keep what they are supposed to. Second, if they don't, extrapolation becomes an agreed upon method of issue quantification.

Contractors, Subcontractors, Sub-Subcontractors, Oh My!

You've selected a vendor for audit and have a really good audit clause in place, or so you think. This particular vendor has a lot of spending and thousands of invoices, so the chance of recovery is high. As you arrive on site and begin reviewing the records, you

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

realize that all of the invoices are one-liners from a subcontractor. The vendor that you are auditing is essentially a middle man who subcontracted all of the work to others, who are the real owners of key documentation. He doesn't have timesheets, supporting documentation, or anything. You ask for the vendor's agreements with his subcontractors. He has some, but not all, and the ones that he does have do not reference or require the subcontractor to keep any documentation, and there is nothing that resembles an audit clause.

If not managed properly, there can be a significant disconnect between the information obtained from the vendor in the bidding process and the actual contract formation. Many vendors might be required to document or identify in their bid documents the percentage or usage of subcontractors, and in some instances, specifically who these vendors are. By the time the vendor is selected and the boilerplate contract language is inserted, there might be little to no reference about the responsibilities of subcontractors to adhere to any contract terms and conditions, including the audit clause.

For contracts where there is a high likelihood that subcontractors might be involved, the organization might want to stipulate through contract and/or audit clause language that certain conditions must be included in all agreements with subcontractors. Such a requirement could be added as standard audit clause language since a vendor could decide at any time to outsource a part or all of a contract to a subcontractor. As an example, *"Vendor agrees that any contracts or agreements with subcontractors that are entered in to in order to support this contract shall include the attached audit clause language. The vendor also*

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

explicitly authorizes the company the ability to exercise its audit rights with any subcontractors.”

NOTES

To Arbitrate or Not to Arbitrate, That Is the Question!

The audit is over and the vendor disagrees with every finding that the audit team has identified. You might even have video footage of scrap being improperly disposed of or contractors sitting down and taking two-hour breaks. The findings are not definitive enough to file charges of outright fraud, but there are definitely improper billings. To add insult to injury, the vendor invokes the arbitration clause to hash out the audit issues. Here are some pitfalls for agreeing to arbitration of audit issues:

- Attack on audit methodology—The time between the audit ending and the arbitration could be weeks or months. This allows for plenty of time for the vendor to hire their own expert and completely invalidate, or at least attack, the audit methodology. Maybe the sample was chosen wrong; maybe certain assumptions were incorrect; or maybe the contract language allowed for certain deviations in billings. The audit might have been performed perfectly, but the process itself might become center stage in the arbitration.
- Attack on management authorization or unclear requests in the field—One of the easiest ways to explain deviations in billings is to blame it on someone else. *Someone told me to do it, someone else authorized it, or someone said it was okay.* If the billing in question occurred two weeks ago, this might be easy to defend, but if the billing occurred three years ago, the field representative will have a difficult time remembering specific authorizations. An issue could be completely voided by having a representative respond, *“It’s possible that I told*

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

them to charge us for that. There was so much going on during that time, I can't really remember."

- Attack on process issues—Process issues might not have been an issue for the vendor when they were making money, but when they are being asked to repay, that could be an entirely different story. For example, let's say that during the period of review there were significant problems with the change order process. Procurement was having issues, and some change orders were issued improperly or not at all. For this audit, you are confident that everything is accurate, but that doesn't stop the vendor from bringing it up and claiming they are a victim of your inefficient processes. Worse, they get you to admit in arbitration that some change orders for other vendors were not issued properly, timely, etc., which might have led to billing issues.
- Inexperience of audit staff in testifying on findings—Your best auditor on the team is a genius, but has the social skills of a foam cup. An arbitration is very similar to a court proceeding, and audit staff could be asked to testify and explain their process and findings. If the delivery comes across as being weak and unsure, the arbitrator might feel that the audit was conducted in the same way.
- Costs, delays, and operational impact—Arbitrations require attorneys and time to prepare and present the case. Regardless of the amount of billings in play, audit time will unfortunately be diverted to support this seemingly never-ending vendor audit. A second issue is whether the vendor is continuing services while waiting for the arbitration to conclude. It could be that the billing errors are so egregious that the organization doesn't want the vendor submitting any more invoices until these

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

issues get resolved. It could also be that the vendor decides to use its leverage and refuses to supply any additional services until they get this issue settled. Regardless of the tactics, there could be operational impacts if the vendor is highly integrated.

The decision on whether to include an arbitration audit clause can depend on many factors. In the previous examples, there are a lot of headaches that can come from a vendor who might be deliberately using the arbitration clause as a way to punish and penalize the organization for conducting the audit. However, an arbitration clause might be a benefit to the contracting organization. If a vendor has a history of being audited and has experience in defending them, an arbitration clause might be warranted. Some vendors might be more knowledgeable of audit methodology and use that knowledge to challenge new and unsuspecting contracting organizations. Another argument for the arbitration clause is that there might be an increased expectation that the vendor might not agree to audit issues and/or repay any overbillings. They could either have a history of being difficult or occupy a spot in the marketplace where they are a limited supplier and ultimately wield significant power.

Regardless as to the reason to include or exclude an arbitration clause, it should be carefully explored and vetted before being included in the audit clause language.

Get Out of Jail Free Clauses

Every so often, a vendor might successfully include *get out of jail free* clauses in either the audit clause language or somewhere else in the contract terms. First and foremost, vendors should not have the ability to

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

NOTES

edit or make changes to audit clause language before contract issuance. This is a right held by the organization, and thus should only be edited or modified by the organization. Simply put, not all procurement professionals realize the importance of the audit clause, nor do they go back and check to make sure that the audit clause that they received back from the vendor is the one that the company originally included. The vendor might have been burned by another vendor audit and is particularly sensitive to audit clause language. This could lead them to try to insert language that negates, or at least muddies, the waters a bit. Here is an example that attempts to weaken the requirement to keep and maintain records:

“Due to the nature of the business, the ability to maintain all necessary documents and supporting documentation might be limited. The owner recognizes this, and the vendor will attempt to maintain as accurate records as possible.”

In another example, a contractor signs a multi-million dollar, fixed-price building construction project of. In the audit clause language, the vendor inserts the following words to exclude them from being audited, all without the procurement employee’s knowledge:

“Owner shall have the right to audit the books and records of the vendor, except on fix-priced contracts.”

When the organization goes to audit the vendor, the vendor responds that fixed-price contracts are excluded from audit, per the audit clause. Be aware that these clauses might be inserted, unknowingly, into the audit clause and contract language. It might also be a good practice to have audit staff review contracts over a certain threshold prior to contract insurance.

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

Sample Right to Audit Clause

Below is a sample right to audit clause that organizations may use to develop their own clause, or to update an existing clause. The sample language, however, is not intended to represent legal advice. Consult with appropriate legal counsel before utilizing this information.

In the sample right-to-audit clause below, the term “Contractor” is used to describe signatories to contracts, grants, and agreements with the [Company] and must be changed to reflect the relationship with the Company (e.g., contractor, licensee, supplier, vendor, consultant, etc.).

Right to Audit

[Contractor] shall establish and maintain a reasonable accounting system that enables [Company] to readily identify [Contractor]’s assets, expenses, costs of goods, and use of funds. [Company] and its authorized representatives shall have the right to audit, to examine, and to make copies of or extracts from all financial and related records (in whatever form they may be kept, whether written, electronic, or other) relating to or pertaining to this [Contract or Agreement] kept by or under the control of the [Contractor], including, but not limited to, those kept by the [Contractor], its employees, agents, assigns, successors, and subcontractors. Such records shall include, but not be limited to, accounting records, written policies and procedures; subcontract files, including proposals of successful and unsuccessful bidders, bid recaps, etc.; all paid vouchers, including those for out-of-pocket expenses; other reimbursement supported by invoices; ledgers; cancelled checks; deposit slips; bank statements; journals; original estimates; estimating work sheets; contract amendments and change order files; back-charge logs and supporting documentation;

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

insurance documents; payroll documents; timesheets; memoranda; and correspondence.

[Contractor] shall, at all times during the term of this [Contract or Agreement] and for a period of ten years after the completion of this [Contract or Agreement], maintain such records, together with such supporting or underlying documents and materials. The [Contractor] shall at any time requested by [Company], whether during or after completion of this [Contract or Agreement], and at [Contractor]'s own expense make such records available for inspection and audit (including copies and extracts of records as required) by [Company]. Such records shall be made available to [Company] during normal business hours at the [Contractor]'s office or place of business and [subject to a three-day written notice/without prior notice]. In the event that no such location is available, then the financial records, together with the supporting or underlying documents and records, shall be made available for audit at a time and location that is convenient for [Company].

[Contractor] shall ensure [Company] has these rights with [Contractor]'s employees, agents, assigns, successors, and subcontractors, and the obligations of these rights shall be explicitly included in any subcontracts or agreements formed between the [Contractor] and any subcontractors to the extent that those subcontracts or agreements relate to fulfillment of the [Contractor]'s obligations to [Company].

Costs of any audits conducted under the authority of this right to audit and not addressed elsewhere will be borne by [Company] unless certain exemption criteria are met. If the audit identifies overpricing or

NOTES

**DESIGNING, INTERPRETING, AND EXECUTING RIGHT TO AUDIT
CLAUSES FOR FRAUD EXAMINERS**

overcharges (of any nature) by the [Contractor] to [Company] in excess of one-half of one percent (.5%) of the total contract billings, the [Contractor] shall reimburse [Company] for the total costs of the audit. If the audit discovers substantive findings related to fraud, misrepresentation, or non-performance, [Company] may recoup the costs of the audit work from the [Contractor]. Any adjustments and/or payments that must be made as a result of any such audit or inspection of the [Contractor]'s invoices and/or records shall be made within a reasonable amount of time (not to exceed 90 days) from presentation of [Company]'s findings to [Contractor].

NOTES