Four Steps to Manage Vendors and Reduce Fraud

By Kelly Gentenaar & Steven Solomon

Are your vendors putting your organization at risk? Follow these steps to minimize the danger.

Nonprofits routinely enter into business transactions with third parties to provide services or otherwise act in their name or under their direction. Yet any time you lend your good name to a third party, such as a vendor, risks can arise. If that third party engages in corrupt or inappropriate actions, such as financial improprieties, violations of your policies, or misrepresentations of the organization's image or ethics, it jeopardizes your nonprofit's most valuable asset—its reputation.

It is essential, therefore, to monitor your relationships with vendors to prevent fraud, waste, abuse, or misrepresentation. Careful planning is critical to assure that these relationships support your nonprofit's mission and reputation—rather than endanger it.

Maintain a Vendor Management Program.

Many nonprofits achieve great results with limited resources by working with third parties. The problem: Decentralized or stripped-down operations, common among nonprofits, are particularly vulnerable to fraud. Organizations too often fail to manage ongoing risks.

Here are a few steps and best practices for an effective vendor risk-management program.

STEP 1: VET YOUR VENDORS.

Source, research, and vet third-party vendors *before* you need their services. Then, when you need them, you won't cut corners in the vetting process due to an emergency situation.

BEST PRACTICES

- **Consider legitimacy and influence.** If the third party is a small, local company, research its legal status and *de facto* control. Likewise, when dealing with an individual or local nongovernmental organization (NGO), take a rigorous look at personal connections with government officials. It can be time-consuming to uncover these personal connections, but it's important to determine the third-party's legitimacy and minimize the risk that the vendor may be a "front" or affiliated inappropriately with local government officials. It's especially critical to exercise caution when dealing with foreign governments or government-affiliated organizations so you don't run into problems with the Foreign Corrupt Practices Act, which forbids bribes to foreign government officials to assist in obtaining or retaining business. U.S. consulates and trade organizations provide resources to help establish third-party legitimacy for U.S. entities doing business abroad, typically free of charge.
- **Justify the need.** Document why and under what circumstances your organization is bringing in a third party. What is the business case for doing so? Answering this question provides clarity and should serve to eliminate ambiguity. Your

> "Don't let a vendor misrepresent your organization."

documentation could take the form of a memorandum of understanding or could be recorded in the minutes of a board meeting.

- **Google it.** Don't discount Google as an information source. Do a Web search for additional background and to spot any inconsistencies or problems related to the entity, including recent news stories or legal troubles.
- **Confirm information.** Require the vendor to submit tax documentation, including its IRS Form W-9 (Request for Taxpayer Identification Number and Certification) to make sure you're dealing with a bona fide organization.
- **Review government watch lists.** If you receive government funding, you must review the various watch lists maintained by relevant governmental bodies. Organizations receiving government funds aren't allowed to do business with companies on the Excluded Party List System, which can be specific to certain government agencies. There are also sector-specific lists such as the List of Excluded Individual/Entities maintained by the U.S. Office of the Inspector General.
- **Up the ante for high-risk activities.** Consider enhanced due diligence for higher-risk activities such as the distribution of medicine or operations in dangerous regions of the world.

STEP 2: HIRE VENDORS WITH CARE.

Successful nonprofits have strong, transparent policies and procedures that document new contractual relationships with third-party vendors or service providers.

BEST PRACTICES

- **Segregate duties.** Make sure one person selects new vendors, and another person approves them. Having more than one set of eyes involved from the beginning is prudent.
- **Create standard vendor agreements** and contract requirements. Most nonprofits will benefit from having standard vendor agreements. Preapproved standard terms and conditions may include items you haven't considered. For example, they will spell out provisions regarding the hiring of subcontractors by the third party, such as the need to notify the nonprofit of subcontractors.
- **Be specific.** Contracts should set forth the exact services that the third party is to provide and the cost for each service. If circumstances don't allow for this, the estimated dollar amount per year (or other time frame) should be included. Keep in mind that the bigger the contract, the more due diligence is required.
- **Include a right-to-audit clause.** You want to know how your funds are being spent. To preserve your position, include a right-to-audit clause in your agreements—and don't be afraid to exercise the right!

STEP 3: MONITOR YOUR VENDORS.

It's important to proactively monitor the third party's transactional behavior against your expectations. Keep track of what the vendor is doing and how much is being spent.

BEST PRACTICES

- **Review transactions.** On a quarterly or semiannual basis, review the transactions of select vendors to see if the source documentation is in line with expectations and in compliance with the contract.
- **Exercise the right to audit** if you spot discrepancies. Including the right-to-audit clause in contracts will provide you with the opportunity to exercise it when you feel that there may be an issue with a vendor.
- **Conduct an investigation.** If you identify transactions that warrant attention, could damage your reputation, or appear suspicious or potentially illegal, conduct a formal investigation.

STEP 4: TRAIN YOUR EMPLOYEES.

Employees or board members charged with vetting, selecting, and approving vendors should be properly trained and educated in the vetting and third-party hiring process. Employees need to be able to do the following:

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GOOD WORK GONE WRONG: REAL-LIFE EXAMPLES FROM THE FIELD

Corruption and poor oversight in overseas contracting threatens government funding.

Issue: An international trade association lacked oversight of its vendor management and contracting process for its 10 overseas offices. The director in one Asian country had numerous behind-the-scenes deals with friends and colleagues to funnel marketing and other consulting work to them. The nonprofit's headquarters had no idea who its vendors were or what they were doing on the organization's behalf.

Resolution: *Our team examined the nonprofit's offices and provided some affordable recommendations:*

- ***Require contracts*** for all vendors, using standard contract terms.
- ***Involve headquarters in the vendor contracting process*** for any expenditures over $10,000.
- ***Monitor all contracts and vendor management processes*** through annual reviews.

The nonprofit's leaders put these suggestions into action. As a result, they enhanced the organization's control environment and were able to continue receiving government funding.

Disaster relief subcontractor falsifies invoices.

Issue: As part of Hurricane Katrina relief, a national nonprofit engaged the Forensic and Valuation practice of our accounting firm, Grant Thornton, LLP, to review its procurement procedures and transactions with a vendor contracted for recovery services. A whistleblower (who was a subcontractor to the vendor in question) brought questionable invoices to the nonprofit's attention.

Resolution: Our review identified duplicate invoices, inaccurate charges, and duplication of services rendered to the nonprofit. These discoveries led to a full review of the vendor's invoices, which uncovered further inappropriate charges. We provided the nonprofit with written recommendations for improved contracting and procurement procedures. The nonprofit forwarded the report to the FBI for further investigation.

AN EFFECTIVE VENDOR MANAGEMENT PROGRAM IN FOUR STEPS

STEPS	Best PRACTICES
1. Vet your vendors	Consider legitimacy and influence Justify the need Google it Confirm information Review relevant government watch lists Up the ante for high-risk activities
2. Hire your vendors carefully	Segregate duties Create standard vendor agreements and contract requirements Be specific Include a right-to-audit clause
3. Monitor your vendors	Review transactions Exercise the right to audit Conduct an investigation
4. Train employees	Know the red flags, risks, and processes

- **Identify the red flags** of suspicious behavior.
- **Understand the organizational and vendor-vetting** processes.
- **Know the risks to the organization** from failing to follow those processes.

Protect Your Mission

Media and regulatory scrutiny of nonprofits is on the rise. You need to protect your organization against the damage that can result from fraud and corruption by third parties acting on your behalf. To do so, establish and maintain effective processes to manage and mitigate the risks inherent in your vendor relationships. This is essential not only to demonstrate proper stewardship but to safeguard your good name, finances, and ultimately your mission.

> "The nonprofit forwarded the report to the FBI for further investigation."

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Better Safe

For more tips on protecting your organization from fraud and other risks, see these articles at www.NonprofitWorld.org/members.

Can Your Organization Afford to Lose $100,000? Safeguards Every Nonprofit Needs to Implement (Vol. 30, No. 3)

Want to Avoid Fraud? Look to Your Board (Vol. 28, No. 5)

New Internal Control Guidance: What You Need to Know (Vol. 28, No. 1)

Protecting your Organization against Financial Misuse (Vol. 17, No. 4)

Setting the Stage for an Abuse-Free Organization (Vol. 30, No. 6)

What Is the Board's Role in Managing Risk? (Vol. 15, No. 5)

Fraud: How to Prevent It in Your Organization (Vol. 26, No. 3)

Holding Conferences in the Face of Terror & Natural Disasters (Vol. 23, No. 6)