COMMON ISSUES IN VENDOR CONTRACT MANAGEMENT AND INVOICING

San Antonio IIA
July 20, 2016

Jeff Dehart, CIA, CISA
INTRODUCTION
Stinnett & Associates, LLC (Stinnett) is a professional advisory firm which excels at maximizing value for both public and private organizations. Our services are designed to help clients more effectively manage risk and improve performance by streamlining processes, reducing costs and enhancing controls.

Stinnett provides a diverse range of services, including:

- Co-source and Outsource Internal Audit
- Governance Risk and Compliance
- Process Design and Re-engineering
- Sarbanes-Oxley
- Fraud Investigation
- Fraud Risk Assessment
- Cost Recovery
- Information Technology
- Enterprise Risk Management

Doing the Right Thing

Founded in 2001, Stinnett has grown to a professional staff of over 40 in 2013. With personnel in Oklahoma City, Tulsa, Dallas, Houston, and San Antonio, we provide services to several Fortune 1000 companies as well as many mid to large size organizations with global operations.

We are primarily recognized for offering relevant advisory assistance and exemplary client service with the unique ability to deliver what our clients need. Working toward solutions, we have a reputation for “doing the right thing.”

Stinnett is a certified Women’s Business Enterprise through the Women’s Business Enterprise National Council. We pride ourselves on being trusted business advisors who focus on assisting clients to reach strategic milestones positioning them for future success.
### STINNETT CLIENT PROFILE

Outlined are clients for whom we have or are currently providing professional advisory services.

<table>
<thead>
<tr>
<th>Internal Audit</th>
<th>Internal Audit and Sarbanes-Oxley</th>
<th>Sarbanes-Oxley</th>
<th>Other Advisory Services</th>
</tr>
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<tbody>
<tr>
<td>- American Heritage Bank</td>
<td>- Alliance Resource Partners, LP</td>
<td>- AAON, Inc.</td>
<td>- Bison Drilling</td>
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<tr>
<td>- Arvest Bank</td>
<td>- Ameris</td>
<td>- FLIR Systems (FKA ICx Technologies)</td>
<td>- Ceja Corporation</td>
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<td>- Commissioners of the Land Office</td>
<td>(FKA SemGroup Energy Partners, LP)</td>
<td>- Halcón Resources (FKA RAM Energy)</td>
<td>- Diamondback Energy (FKA Windsor Energy)</td>
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<tr>
<td>- Concho Resources, Inc.</td>
<td>- Energy Transfer Partners, LP</td>
<td>- Keen Energy Services, LLC</td>
<td>- Educational Concepts, LLC</td>
</tr>
<tr>
<td>- Denali</td>
<td>- Global Power Equipment Group</td>
<td>- Mid-Con Energy Partners, LP</td>
<td>- FW Murphy</td>
</tr>
<tr>
<td>- Explorer Pipeline</td>
<td>Helmerich &amp; Payne</td>
<td>- North American Galvanizing</td>
<td>- Great White Energy</td>
</tr>
<tr>
<td>- Flinco Construction Company</td>
<td>The Hertz Corporation</td>
<td>- Orchids Paper Products Company</td>
<td>- MidFirst Bank</td>
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<td>- Hobby Lobby Stores, Inc.</td>
<td>- Kirby Corporation</td>
<td>- Pioneer Energy Services</td>
<td>- Premier Natural Resources</td>
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<td>- NORDAM</td>
<td>- LSB Industries, Inc.</td>
<td>- PostRock Energy Corporation</td>
<td>- SERVAgroup</td>
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<tr>
<td>- Oklahoma State University Alumni Association</td>
<td>- Laredo Petroleum, Inc.</td>
<td>- RKI Exploration &amp; Production, LLC</td>
<td>- Samson Resources</td>
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<td>- Oklahoma State University Foundation</td>
<td>- Magellan, LP</td>
<td>- Seminole Energy Services</td>
<td>- Texas Children’s Hospital</td>
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<td>- Oklahoma Teachers Retirement System</td>
<td>- Matrix Service Company</td>
<td>- Southcross Energy</td>
<td>- Total Information Services</td>
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<tr>
<td>- Oral Roberts University</td>
<td>- Memorial Production Partners</td>
<td>- Syntroleum Corporation</td>
<td>- Vintage Petroleum (prior to sale to Occidental)</td>
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<tr>
<td>- T.D. Williamson, Inc.</td>
<td>- OGE Energy Corporation ONEOK, Inc.</td>
<td>- SemGroup, LP</td>
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<tr>
<td>- University of the Incarnate Word</td>
<td>- Regency Energy Partners</td>
<td>The Williams Companies, Inc.</td>
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<td>- University of Oklahoma Foundation</td>
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<td>- USAA</td>
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</tbody>
</table>

*Fortune 1000 company*
JEFF DEHART, CIA, CISA

- Principal with Stinnett & Associates.
- Over 30 years of experience in both Audit and Information Technology
- Worked for several large organizations including Williams Companies and Magellan Midstream Partners.
- Has held such positions as Associate General Auditor, Director of Audit Services, and Information Technology Manager.

**Experience Includes:**

<table>
<thead>
<tr>
<th>Enterprise Business Continuity Planning</th>
<th>Oil And Gas Field Operations</th>
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</thead>
<tbody>
<tr>
<td>Construction Management Auditing And Consulting</td>
<td>Aerospace Manufacturing And MRO (Maintenance, Repair And Operations)</td>
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<tr>
<td>Inventory Management Advisory</td>
<td>IT Network Security</td>
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<td>Internal Audit Management Services,</td>
<td>SCADA Security And Operations Control</td>
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<tr>
<td>Business Process Re-engineering</td>
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AGENDA

Vendor Risk

Issues in Vendor Invoicing

Contract Considerations

Fraud Trends
VENDOR RISK

Why is vendor contract management important?

Examples of risks associated with using 3rd party vendors:

⚠ Reputation risks such as dissatisfied customers as a result of non-performance of services resulting in poor quality and/or delays;

⚠ Compliance risks such as violations of laws, rules, regulations or noncompliance with policies or procedures resulting;
VENDOR RISK (CONTINUED)

Risks associated with using 3rd party vendors:

⚠️ Operational risks such as losses from failed processes or systems or losses of data that result in privacy issues;

⚠️ Transaction risks such as overcharging, inappropriate costs even fraud;

⚠️ Credit risks such as the inability of a third party to meet its contractual obligations.
ISSUES IN VENDOR INVOICING
LABOR CHARGES — WHAT TO LOOK FOR

- Accurate labor rates for job classification per contract / rate sheet for that time period
- Hours/days billed are accurate per supporting timesheets
- Hours/days billed for holiday/PTO/downtime in accordance with contract
- Hours/days billed after employee termination/job completion
- Duplicate hours/days billed across multiple invoices/time periods
- Excessive hours/days
**EXAMPLE: EXCESSIVE TIME**

<table>
<thead>
<tr>
<th>Billing Title</th>
<th>Activity Code</th>
<th>Regular</th>
<th>OT</th>
<th>Days</th>
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<td>7.00</td>
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</table>

- Weekly billing invoice for labor rates
- Employees are billed at a daily rate for the week
- Total of 48 employees were noted as billing at more than 7 days per week over the course of the project
EXAMPLE: RATE BY SKILL LEVEL

Recent trend in labor rates that can result in significant overcharges or the inappropriate skill level.

- Rate sheets typically show various rates for different skill levels by position with higher rates for more skilled workers.
- Some vendors will charge all personnel at the highest skill level in each job category.

**Result:** Although the labor rate is legitimate, the resulting costs are not. Not getting skill level requested or required.
REIMBURSABLE EXPENSES — WHAT TO LOOK FOR

- Type of expenses allowed per contract
- If there is a mark up on the expense, it is allowable per the contract?
- Per diem rates are accurate per contract or IRS rates, such as
  - Per diem / incidentals charged on days not worked
  - Per diem and same day meal/hotel charges
Reasonable mileage expenses given work locations

Rental cars / vehicle use charges and mileage

Prior period expenses re-submitted/billed twice

Illegible / Inaccurate receipts per expense charge
Issues with incorrect or disallowed per diem charges being billed to customers:

- Per diems for days not traveled
- Per diems for weekends and holidays
- Per diem charges for office personnel working at their normal office
- Incorrect per diem rates (particularly for those charged according to indexes)
EXAMPLES: MARKUPS

Issues with markup errors include:

💰 Markups on items that should not be allowed, such as per diems and employee expenses.

💰 Markups for office equipment use

💰 In most cases, markups are allowed for work the contractor “farms out” to subcontractors. However, we have seen cases where they will create a “subcontractor” within their company, move the work to that division and charge the subcontractor markup.
Proper rates are applied

Equipment reasonable given type or work

Third party equipment rentals – detailed support is available

Reasonable equipment rental time to labor hours worked
Vendors frequently rent equipment for the contracted work. Issues with equipment rentals include:

- Higher equipment rates than agreed upon
- Equipment charges that are for more hours per day than the workers are working
- Charges for holidays and weekends, when workers are not present
- Charges for equipment not actually used on job. Instead, they are used for other customers’ projects
§ 7.5.2 Rental charges for temporary facilities, machinery, equipment and hand tools not customarily owned by construction workers that are provided by the Contractor at the site and costs of transportation, installation, minor repairs, dismantling and removal. The total rental cost of any Contractor-owned item may not exceed the purchase price of any comparable item. Rates of Contractor-owned equipment and quantities of equipment shall be subject to the Owner’s prior approval.
## Equipment Rental Analysis

<table>
<thead>
<tr>
<th>Equipment Description</th>
<th>Rental Charges Paid</th>
<th>Contractor Acquisition Cost</th>
<th>Acquisition Date</th>
<th>Average Replacement Cost</th>
<th>Model #</th>
<th>Year</th>
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</thead>
<tbody>
<tr>
<td>Backhoe</td>
<td>$38,031.99</td>
<td>$40,640.63</td>
<td>Dec-07</td>
<td>$35,845.50</td>
<td>Case 580M</td>
<td>2004</td>
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<tr>
<td>Laser</td>
<td>$2,898.45</td>
<td>$1,066.41</td>
<td>Dec-10</td>
<td>$825.80</td>
<td>Topcon RL-H3CL</td>
<td>2010</td>
</tr>
<tr>
<td>Sump Pump</td>
<td>$353.14</td>
<td>$363.06</td>
<td>Dec-09</td>
<td>Same as acquisition cost.</td>
<td>Multiquip</td>
<td>2009</td>
</tr>
<tr>
<td>Trash Pump</td>
<td>$487.98</td>
<td>$357.64</td>
<td>Dec-09</td>
<td>Same as acquisition cost.</td>
<td>Honda 2&quot;</td>
<td>2009</td>
</tr>
</tbody>
</table>
OBJECTIVE OF CONTRACTS

- The objective of a contract is rarely achieved simply by entering into an agreement.
- How the contract is to perform and how it will be managed must be incorporated during the tender and negotiation process to ensure it is effective.
- Unless it is monitored and responsibilities for achieving the objectives are shared, it is unlikely to deliver the expected value.
3 KEY AREAS TO CONTRACT MANAGEMENT

- Negotiating and developing very clearly defined and complete contracts
- Monitoring the invoices against the terms of the contract and service against performance metrics
- Managing the vendor relationship
SIGNS OF EFFECTIVE CONTRACT MANAGEMENT

- Satisfaction and value for money are realized by both parties
- No surprises, disputes, disruptions in service by either party
- Changes to the contracts can be made objectively and professionally
- Competitive advantages are realized
IMPORTANT CONTRACT ELEMENTS

- Scope of Service
- Performance Standards
- Security and Confidentiality
- Records Retention and Right to Audit
- Sub-Contracting and Multiple Service Provider Relationships
- Termination
- Regulatory Compliance
# Contract Administration

<table>
<thead>
<tr>
<th>Right to Audit Clause</th>
<th>Clear Contract Terms</th>
<th>Subcontractor Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Master Service Agreements</td>
<td>• Reimbursable costs are specific</td>
<td>• Terms of agreement should be consistent with owner contract</td>
</tr>
<tr>
<td>• Purchase Orders – if no MSA, should have RTA in PO</td>
<td>• Key contract terms are defined prior to executing contract</td>
<td></td>
</tr>
</tbody>
</table>

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*STINNETT & ASSOCIATES*
Records and Audit. Contractor is required to maintain receipts, canceled checks, vouchers, records, invoices, and sufficiently documented and properly reflect all costs and expenditures incurred by Contractor, and the equipment provided by Company. Such records shall be maintained and, but not be limited to, support all direct and indirect costs incurred by the Contractor, and other evidence which would enable Company employees to evaluate Contractor’s compliance to Company’s policies and procedures. All costs and expenditures incurred by Contractor in the completion of the Work shall be recorded in such form and detail as to enable ready computation and audit of such costs. Contractor shall preserve and make available all such records for a period of three (3) years after completion or termination of the Work. Contractor will require all subcontractors to comply with the provisions of the paragraph by insertion of these requirements in a written agreement between Contractor and subcontractor.

Such records shall be open to inspection and subject to audit and reproduction during normal working hours of the Company, including any public accounting firm selected by it. Inspection and audit shall be performed by contractors or subcontractors for the Company, to allow for the adequate evaluation and verification of the Contractor’s costs and subsequent invoices, Work Orders, etc., submitted to the Company. Records which will be subject to audit include, but are not limited to: (a) payroll records accounting for total time distribution of Contractor’s employees working full or part-time on the Work (to permit tracing of payroll records and related tax returns), as well as canceled payroll checks, or signed receipts for payroll payments made in cash; (b) invoices for purchases, receiving and issuing documents, and all other inventory records for Contractor’s stores stock or capital items; (c) paid invoices and canceled checks for material purchased and for subcontractors’ and any other third parties’ charges, including, but not limited to, equipment rental; and (d) travel, lodging, meals and entertainment documentation (including, but not limited to, employee expense reports and Contractor facility usage reports). Company’s right to audit shall extend to any Change Orders or other price adjustments made in connection with this Agreement.

Company’s agents shall have prompt access to Contractor’s facilities and shall be provided with adequate working space and telephone in order to conduct the audit. These will be provided at no cost to the Company.

If an audit inspection or examination conducted in accordance with this paragraph discloses overcharges and/or greater than $5,000 or 1% of total billings for Work performed under this Agreement, whichever is greater, then the Contractor shall reimburse Company for all costs incurred to conduct the audit.

Contractor shall require all subcontractors to comply with these audit provisions. Contractor’s subcontractors shall make available in an expeditious manner any records, documents, and any other information requested by Company.
Records and Audit. Contractor is required to maintain receipts, canceled checks, vouchers, records, invoices for purchases, rate schedules, etc. to sufficiently document and properly reflect all costs and expenditures incurred by Contractor, and the disposition of any materials, tools, or equipment provided by Company. Such records maintained shall include, but not be limited to, support for costs invoiced to the Company, all direct and indirect costs incurred by the Contractor, and other evidence which would enable Company employees to evaluate Contractor's compliance to Company's policies and procedures. All costs and expenditures incurred by Contractor in the completion of the Work shall be recorded in such form and detail as to enable ready computation and audit of such costs. Contractor shall preserve and make available all such records for a period of three (3) years after completion or termination of the Work. Contractor will require all subcontractors to comply with the provisions of the paragraph by insertion of these requirements in a written agreement between Contractor and subcontractor.
Such records shall be open to inspection and subject to audit and reproduction during normal working hours by Company's agent or its authorized representatives, including any public accounting firm selected by it. Inspection and audit shall be performed as deemed necessary by the Company, to allow for the adequate evaluation and verification of the Contractor's costs and subsequent invoices, Work Offers, etc., submitted to the Company. Records which will be subject to audit include, but are not limited to: (a) payroll records accounting for total time distribution of Contractor's employees working full or part-time on the Work (to permit tracing of payroll records and related tax returns), as well as canceled payroll checks, or signed receipts for payroll payments made in cash; (b) invoices for purchases, receiving and issuing documents, and all other inventory records for Contractor's stores stock or capital items; (c) paid invoices and canceled checks for material purchased and for subcontractors' and any other third parties' charges, including, but not limited to, equipment rental; and (d) travel, lodging, meals and entertainment documentation (including, but not limited to, employee expense reports and Contractor facility usage reports). Company's right to audit shall extend to any Change Orders or other price adjustments made in connection with this Agreement.
If an audit inspection or examination conducted in accordance with this paragraph discloses overcharges of any nature by Contractor to Company greater than $5,000 or 1% of total billings for Work performed under this Agreement, whichever is greater, then the Contractor shall reimburse Company for all costs incurred to conduct the audit.
Subcontractors should be subject to main contract audit clause

Type of contract should not matter

§ 10.3 Subcontracts or other agreements shall conform to the applicable payment provisions of this Agreement, and shall not be awarded on the basis of cost plus a fee without the prior consent of the Owner. If the Subcontract is awarded on a cost-plus a fee basis, the Contractor shall provide in the Subcontract for the Owner to receive the same audit rights with regard to the Subcontractor as the Owner receives with regard to the Contractor in Article 11, below.
COLLUSION WITH VENDOR

Case Example:

- Vendor: Fire and security systems and maintenance

- Supervisor in security office who oversaw fire safety and security systems colluded with vendor to create a fake company with “fire safety” in title

- Fake company submitted bogus invoices for 10 years ($2.6 million over 5 years was uncovered due to document retention policy)

- Discovered randomly by another employee who actually performed the services and saw the invoices on admin’s desk

- Supervisor received about 90% of the invoice payments

- Red flag: Supervisor regularly entered $250,000 poker tournaments and casinos would send a jet to pick him up
CONFLICT OF INTEREST WEB

Case Example:

- Original conflict of interest discovered between our client and vendor #1 (employee’s wife owned a company that subcontracted with vendor). Not disclosed, but vendor assumed everyone knew and “that is just how you do business.”

- Vendor #1 revealed another conflict that another client employee had with vendor #2. Assumed the conflict was a relationship between employee and vendor #2.

- This client employee was approving all the invoices for vendor #2

- Review of state filing documentation revealed employee was part owner of an LLC, which was part owner of vendor #2.

- Other partial owner of vendor #2 also did business with the client

- Do you require your vendors to sign a conflict of interest statement?
FAKE LABOR AND EXPENSE CHARGES

Case Example:

- Vendor invoicing for labor and expenses of “fake” employees
- Project manager with vendor set up “fake” vendor employees who never worked on project
- Invoiced over $1.6 million in bogus charges for 4 fake employees (labor rates, per diem and other reimbursable expenses over a year and a half)
- Discovered when control of supervisor sign off required on timesheets was enforced
IMPORTANCE OF RELATIONSHIP MANAGEMENT

One of the keys to preventing overcharges and/or fraud related to vendor contracts is relationship management and monitoring.

- **KNOW** your vendor (meet with vendor regularly; know the vendor employee names and ask for resumes up front).

- **REVIEW** invoices against contract terms and for unusual trends and point out inconsistencies when you find them.

- **HOLD** your vendor accountable for the contract terms, point out errors or overcharges immediately, and if necessary terminate the contract.
QUESTIONS?

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MANAGING RISK. IMPROVING PERFORMANCE.

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