

Te Kāwanatanga o Aotearoa
New Zealand Government

Summary

Procurement fraud and corruption risk

Building fraud and corruption
prevention capability and culture
in the public sector

The Serious Fraud Office Te Tari Hara Tāware is the lead law enforcement agency for investigating and prosecuting serious or complex fraud, including bribery and corruption. It works to strengthen the public sector's resilience to fraud and corruption through its Counter Fraud Centre Tauārai Hara Tāware.

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Introduction

Procurement is the process that organisations use to get the goods and services they need. It can range from simple, low-risk transactions to complex, high-risk undertakings. Procurement starts by identifying a need and ends with either the completion of a service contract or the disposal of an asset. This is known as the procurement lifecycle.

A robust procurement process follows a set of rules and procedures to support a transparent, fair and efficient process that promotes good practices and reduces the risk of fraud and corruption.

This resource will be helpful for any employee involved at any stage of procurement. It examines what procurement fraud and corruption looks like and where the risks lie, how to recognise warning signs or red flags of potential fraud, and what countermeasures can be put in place to help reduce the risk of fraud and corruption happening at all.

Procurement in the public sector

New Zealand's public sector spends over \$51 billion on procurement every year, so efficient procurement of public goods and services is needed to support the nation's economy and wellbeing.

Public procurement covers a wide range of purchases, from everyday items like office supplies and healthcare services to complex contracts for infrastructure projects, defence equipment and consulting services.

Public value in procurement means getting the most out of public funds when purchasing goods, services or works. It does not necessarily mean choosing the lowest price but rather the best possible outcome for the total cost over the whole life of the goods, services or works.

Risks to the procurement process

The procurement process – from the planning stages through to contract management – is vulnerable to inefficiencies, abuse and waste, and at its worst, fraud and corruption. From unclear requirements and unfair bid evaluations to inflated prices and not following contract terms, these risks can have significant financial outcomes.

Public sector procurement is a prime target for fraud and corruption because:

- ▶ there are large volumes of transactions
- ▶ significant amounts of money are at stake
- ▶ the process is often complex
- ▶ close interaction between public sector employees and private sector businesses
- ▶ multiple stakeholders are involved
- ▶ fraud and corruption is difficult to detect
- ▶ there is a general lack of knowledge about fraud, corruption and prevention.

Reducing the risk of procurement fraud and corruption

Prevention is the most cost-effective way to reduce fraud and corruption risk. Organisations should prioritise prevention to protect themselves from financial loss, reputational damage and legal consequences. By understanding the conditions that can lead to fraud and corruption and putting in place effective countermeasures, organisations can protect public funds and maintain the integrity of their procurement processes.

A robust and well-structured procurement process is the first line of defence against procurement fraud and corruption. While a formal procurement process may be viewed as difficult or time consuming, it is essential to examine the entire procurement lifecycle and follow a series of basic steps for any procurement activity.

For more in-depth information about how to identify and prevent procurement fraud and corruption see *Procurement fraud and corruption risk: Building fraud and corruption prevention capability and culture in the public sector*.¹

¹ See <https://www.sfo.govt.nz/counterfraud/cfc/resources/guides-and-factsheets/procurement-fraud-and-corruption-risk>.

What is procurement fraud and corruption?

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Fraud and corruption in the procurement process each involve criminal behaviour. Sometimes this criminal behaviour is both fraudulent and corrupt, for example where a public sector employee accepts kickbacks or bribes in return for approving false invoices. However, while the acts of fraud and corruption can be similar, not all fraudulent acts involve corruption and vice versa.

Procurement fraud is deliberate, dishonest behaviour that exploits one or more stages of the procurement process to secure unfair or unlawful financial gain or cause losses. It can be carried out by suppliers, vendors, subcontractors or internal staff.

Procurement fraud takes many forms. It can include false invoicing or overbilling, submitting fake documents or product substitution. For example, a contractor submits invoices for equipment that was never delivered or inflates the cost of services. No public sector employee was involved in the fraud, the contractor simply manipulated the documentation to receive more money.

Procurement corruption involves the abuse of power for personal gain. It typically involves unethical behaviour by public sector employees with decision-making power. For example, a public sector employee awards procurement contracts to companies they have a link to, in exchange for a personal benefit.

Challenges of procurement fraud and corruption

Difficult to detect

Identifying procurement fraud and corruption can be challenging because the procurement process is complex and involves multiple stakeholders. Most fraud and corruption cases are discovered through tip-offs by employees about unusual behaviour.

Difficult to measure

Measuring the true cost of procurement fraud and corruption is complex. Unlike other financial losses, procurement fraud and corruption is often hidden or unreported. This invisibility makes it difficult to determine the exact scale of how much money has been lost.

Difficult to address

Traditionally, public sector fraud and corruption has been tackled through reactive measures such as investigations, prosecutions and penalties. While it is important to hold fraudsters to account, this approach can be slow and costly and may not lead to the recovery of lost funds or achieve convictions.

Lack of awareness

A major obstacle to preventing procurement fraud and corruption is the lack of focus on fraud risks during planning. Many projects lack a risk assessment for procurement fraud and corruption, which leads to no fraud controls or plans for how to reduce the risk of fraud and corruption.



Impacts of procurement fraud and corruption

Procurement fraud and corruption is not just a financial crime, it creates a ripple effect of negative consequences that pose a serious risk to the public sector, economy, people and the environment.

Strained service delivery

When fraud and corruption divert public funds from crucial areas such as welfare, health and infrastructure it leads to a decline in the quality of services. Government agencies cannot effectively deliver vital services to citizens who need them most, and agencies face the added burden of investigating and prosecuting fraud and corruption, which slows things down further.

Reputational damage and loss of public confidence

Fraud and corruption can damage the reputation of New Zealand's public institutions and lead to a loss of public trust and international standing. Fraud and corruption scandals erode public confidence in government and its ability to manage public funds effectively, which can have political and economic consequences.

Human and environmental impacts

Public sector fraud and corruption is not a victimless crime. It can cause trauma, with real and irreversible impacts for victims and their whānau. Such crimes can also lead to a sense of betrayal and loss of trust for those close to the offender.

Fraud and corruption in public sector procurement can lead to immediate and long-term environmental harm through pollution and damage to ecosystems. This poses risks to our cultural values, natural resources and agricultural industry.

Threats to security and industry

Fraud and corruption in public sector procurement can compromise national defence and security and put New Zealanders at risk from organised crime and terrorist groups. Such crimes can result in distorted markets where fraudsters gain a competitive advantage and drive out legitimate business. Fraud and corruption can also compromise border security, resulting in biosecurity risks and trafficking of illegal goods.

Procurement fraud and corruption risks

Different types of fraud and corruption can happen at different stages of procurement, and each stage carries its own unique fraud risks. Understanding the risks and red flags at each stage is key to effectively preventing them.

Red flags are a warning signs of potential fraud and corruption. They indicate unusual or suspicious behaviour or circumstances that should be checked more closely to see if there is a problem or risk.

Fraud and corruption can happen even with initial safeguards in place if fraudsters can exploit weaknesses in the system. By recognising the diverse nature of procurement fraud and corruption, organisations can set up effective prevention and mitigation measures at every stage of the procurement process.

Employee fraud and corruption

This type of fraud and corruption happens when an employee manipulates the procurement process for financial gain, often through deception and misrepresentation.

An employee could:

- ▶ create a false need for goods or service
- ▶ buy goods or services in quantities much more than what is reasonably needed by the organisation
- ▶ make unauthorised payments or disbursements from company funds
- ▶ steal assets, such as cash, inventory or equipment.

Red flags

- ▶ Unusual or excessive requirements for specialised goods or services.
- ▶ Signs of increased wealth or lavish spending habits, such as expensive purchases or frequent holidays.
- ▶ Resistance to budget scrutiny or questioning.
- ▶ Delayed payments or confusion in the accounting records to hide fraudulent transactions.

Collusion between employees and suppliers

This type of procurement fraud and corruption can happen when an employee works with a supplier to manipulate the procurement process. This means they misuse their position to unfairly advantage that supplier for a contract, often for personal gain.

An employee could:

- ▶ manipulate bid specifications or evaluation criteria to favour a particular supplier or contractor
- ▶ award a contract to a single supplier without fair competition
- ▶ break a large contract down into smaller, separate contracts to avoid competitive bidding or favour a specific supplier
- ▶ influence the bidding process to award a contract to a favoured bidder or rig the price of a contract.

Red flags

- ▶ Overly vague or specific requirements in bid specifications.
- ▶ Significant cost increases or unnecessary upgrades after a contract is awarded.
- ▶ A close relationship between an internal employee and a favoured supplier.
- ▶ Several small contracts instead of a single large contract.

Supplier fraud and corruption

This type of fraud can happen when a supplier manipulates the procurement process for financial gain, often by lying or deceiving. There are several common schemes designed to exploit weaknesses in an organisation's procurement controls.

A supplier could:

- ▶ provide goods or services that do not meet the expected quality or standards, while still getting full payment
- ▶ request or make changes to a contract or project that are unnecessary, excessive or unjustified to increase their profits
- ▶ submit false invoices to a client or customer then seek payment for goods or services that were never provided, were not the promised quality or were at a higher price than agreed upon
- ▶ supply false information about their goods, services or business practices to deceive clients or customers for personal gain.

Red flags

- ▶ Multiple reviews or testimonials use identical or very similar language, suggesting they may be fabricated.
- ▶ A company has a limited or no online or market presence, such as a website or social media accounts.
- ▶ Contract specifications are intentionally vague to allow for later change orders.
- ▶ A pattern of change orders just below the approval threshold to avoid increased scrutiny.
- ▶ A supplier's bid is significantly less than other bids, suggesting they may be willing to compromise quality or ethical standards to win the contract.



Collusion between suppliers

This type of fraud can happen when suppliers work together to fix prices, restrict outputs, exclude competitors or exploit customers.

Suppliers could agree to:

- ▶ manipulate the outcome of a bid or auction to ensure that one specific bidder among them will emerge as the winner
- ▶ divide up markets among themselves and allocate customers, contracts, products or geographic regions to specific suppliers
- ▶ set or manipulate the price of goods or services to establish minimum prices, increase prices or avoid price competition
- ▶ reduce or limit the supply of goods or services to create scarcity and increase prices or protect less efficient suppliers.

Red flags

- ▶ A pattern where the same group of companies consistently win bids in a recurring sequence.
- ▶ The same company consistently wins contracts in a particular region, while other companies rarely bid or win in that area.
- ▶ The price of supplies consistently increases over time, even without changes in market conditions or other costs.
- ▶ Competitors consistently raise or lower prices by similar amounts at approximately the same time.
- ▶ A sharp decline in prices after a new supplier enters the market.



Procurement fraud and corruption countermeasures

Reducing the risk of procurement fraud and corruption requires a multi-layered approach that addresses the opportunities for fraudulent activity, establishes robust controls and fosters a culture of integrity.

By putting countermeasures in place, organisations can considerably reduce their exposure to procurement fraud and corruption risk and enhance the integrity of their procurement processes. A strong ethical culture is crucial to deterring and preventing fraud and corruption risks and should be the foundation of an organisation's counter fraud and corruption approach.

Policies and procedures

Organisational policies and procedures are the formal guidelines that govern how an organisation operates. They provide a framework for decision making and action and create a structured environment where everyone understands their roles, responsibilities and the expected course of action. This minimises risks, improves efficiency and promotes a consistent and ethical approach to all aspects of the organisation's operations.

The following are some key policies and procedures that help manage the risk of procurement fraud and corruption within an organisation (this list is not exhaustive):

- ▶ risk management policy
- ▶ fraud and corruption policy
- ▶ procurement policy and procedures
- ▶ conflicts of interest policy
- ▶ gifts and hospitality policy and register
- ▶ records policy
- ▶ supplier contract management.

These documents should:

- ▶ guide how a process is carried out
- ▶ help manage fraud and corruption risks
- ▶ outline what must be done to strengthen weaknesses in a system
- ▶ communicate reporting channels and processes
- ▶ clearly set out standards of integrity and expected codes of conduct
- ▶ explain any consequences of not following the correct procedures.

Employee counter fraud training and awareness

Robust training and communication programmes will assist an organisation to combat fraud and corruption by raising awareness of the risks.

The hidden nature of fraud and corruption makes it challenging to detect. Employees are in the best position to notice suspicious activity among colleagues or raise concerns about contractors or suppliers.

Training plays a crucial role in helping to prevent procurement fraud by equipping employees with the knowledge and skills to identify, prevent and report suspicious activities. Fraud and corruption can go undetected for some time because employees do not recognise red flags, are uncertain about reporting procedures or lack confidence in existing reporting systems.

Empowering employees to play a role in protecting the organisation can boost morale and engagement. A transparent and ethical work environment fosters a positive and productive atmosphere, and a strong counter fraud culture demonstrates ethical behaviour and responsible business practices. This helps to build trust with stakeholders, including customers, suppliers and the public.

To help combat fraud and corruption, robust training and communication programmes should:

- ▶ equip employees with knowledge and skills
- ▶ provide real-life examples
- ▶ explain policies and procedures
- ▶ share responsibility among employees and teams
- ▶ cultivate a culture of organisational integrity
- ▶ establish clear and confidential communication and reporting channels.

Supplier counter fraud awareness

Healthy and ethical relationships with suppliers and contractors are key to the success of any organisation. However, blind reliance on third parties can expose organisations to significant risks, including misconduct and fraud. Even reputable suppliers can be vulnerable to internal breaches, and collusion between their employees and those within another organisation can create significant vulnerabilities.

To help mitigate these risks, establish clear expectations and cultivate a culture of trust and transparency throughout the entire supplier engagement process, including:

- ▶ clearly defined ethical standards
- ▶ clear and comprehensive agreements and contracts
- ▶ zero tolerance for misconduct.

Checks and balances

Supplier selection due diligence

Thorough inspection of potential suppliers can help organisations to identify and prevent fraudulent activities such as bribery, kickbacks and collusion. Robust financial checks can reveal potential red flags like insolvency, high debt levels or a history of financial irregularities before any work begins. A supplier's operations should be reviewed, including their quality control systems, delivery track record and safety practices, to help minimise the risk of goods or services that are not up to standard.

Segregation of duties

Separating procurement duties, particularly for purchasing, approval and payments, helps to reduce the risk of fraud and corruption by limiting the ability of any one employee to control and manipulate the entire procurement process. Multiple employees should review different parts of a transaction to increase the chance of detecting errors or inconsistencies that may mean fraud or corruption is happening. For example, one employee may undertake purchasing or invoicing, while a different employee reviews and approves the purchase order or payment. By distributing responsibilities, it helps to minimise the risk of human error or deliberate misconduct and ensure that transactions are processed accurately.

Contract transparency

Making contract information, such as supplier details, award criteria or contract awards, publicly known discourages bribery and favouritism. It enhances public scrutiny and ensures all eligible suppliers have a fair chance to compete.

Performance monitoring

Regularly tracking supplier performance means organisations may be able to identify and address performance issues early, hold suppliers accountable and ensure they are receiving the best value for their investment. Close monitoring helps to hold suppliers accountable for their actions and ensure they follow the terms of the contract. This scrutiny also deters fraudulent behaviour as suppliers know that their performance is being monitored and that any deviations will be investigated.

Pattern recognition

By reviewing historical procurement data, organisations can identify unusual changes or differences that may mean fraud and corruption is happening. Pattern recognition can provide valuable insights into procurement trends and supplier behaviour, for example, if the system detects an unusual pattern of payments, it can trigger a closer examination of that supplier's activities.

Audits

Internal audits examine transactions, contracts and supplier relationships for anything unusual or signs of fraud such as duplicate payments. By examining payment records and assessing how effective existing controls are, audits may find weaknesses that could be exploited by fraudsters, then improvements to strengthen controls can be put in place. Internal audits help to reassure management and stakeholders that procurement processes are operating effectively and ethically, and that risks of fraud and corruption are being adequately dealt with. Regular audits also promote accountability among employees involved in the payment process, which can help to deter fraud and corruption.

Random checks

Random checks help uncover fraud and corruption that may not be found through routine audits or reviews. By choosing transactions or suppliers randomly, auditors may identify irregularities that could otherwise go unnoticed. The unpredictability of random checks can also discourage fraudulent behaviour, as people may be less likely to engage in illegal activities if they believe they could be found out. Random checks can expose weaknesses in internal controls and reinforce the need to follow proper procurement policies and regulations.

Probity review

Probity reviews assess how ethical and fair the entire procurement process is. This type of review examines whether decisions were made without bias and in the best interests of the organisation. Probity reviews scrutinise potential conflicts of interest among decision makers, suppliers and other stakeholders, and help to ensure that ethical guidelines, codes of conduct and relevant laws are followed so public funds are used effectively, efficiently and ethically.

Probity principles require clear and transparent records of all procurement decisions and activities. This improves accountability and makes it easier to identify and investigate any irregularities or potential wrongdoing. Probity principles also ensure all suppliers have a fair and equal opportunity to participate in the procurement process, which reduces the risk of collusion or bid rigging.

Systems

Automated systems

Automated systems can reduce the risk of procurement fraud and corruption by enabling real-time monitoring, advanced data analysis and processes that do not rely on human intervention. This may lead to early detection of anything unusual, reduces reliance on manual processes that are prone to error and can improve overall efficiency and accuracy.

Audit trails

Audit trails are an important part of procurement record keeping. These trails track every action taken within a system, including user logins, data entry, approvals and modifications, and provide a complete history of all transactions. By analysing audit trails, auditors may identify suspicious activity, such as unauthorised access, data manipulation or unusual patterns of behaviour. Records can also provide crucial evidence for investigating suspected fraud and corruption cases.

Data analytics

Data analytics empowers organisations to proactively manage procurement fraud and corruption by analysing large volumes of data. By providing data-driven insights, analytics supports organisations to make better-informed procurement decisions, such as identifying reliable and trustworthy suppliers. Data analytics can be used to develop predictive models that help to identify potential fraud and corruption vulnerabilities and high-risk areas within the procurement process. Procurement activities can also be continually monitored to identify unusual patterns. During fraud and corruption investigations, data analytics may provide valuable insights to identify key individuals, reconstruct the sequence of events and gather evidence to support legal action.

Reporting mechanisms

Whistleblower hotlines

Confidential and secure channels for employees to anonymously report suspected or actual instances of fraud, corruption, misconduct or unethical behaviour are important to have in place. Whistleblowers need assurance that their identity will remain protected and that they are safe from any harm for revealing information about wrongdoing.

By providing a confidential avenue for reporting, hotlines or other channels support early detection of potential fraud and corruption so organisations can investigate and address issues before they escalate and cause significant financial damage. By analysing reported concerns, organisations may also identify weaknesses in their internal controls and implement measures to mitigate risks and prevent future fraud or corruption.



Capability and culture

There is no single solution to fraud and corruption risk. Processes need to continually improve to mitigate rapidly evolving fraud and corruption threats, and leaders should model ethical conduct to cultivate a culture of integrity. Although there will always be fraud and corruption, prevention is the most cost-effective way to reduce the risk of it occurring.

A robust procurement process is comprehensive, transparent and adhered to. By implementing a suite of robust policies and procedures, training employees in counter fraud and corruption approaches, closely monitoring suppliers and contractors, putting in place effective checks and balances, and providing secure fraud and corruption reporting channels, organisations can considerably reduce and manage their risk of procurement fraud and corruption.

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The Counter Fraud Centre offers a range of resources, webinars, workshops and services free to public sector organisations to help build their counter fraud capability and create an effective counter fraud culture. Find out more at sfo.govt.nz/counterfraud/cfc.

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