

Governance: A Procurement Perspective

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Abstract

Substantial attention has recently been given to governance and internal control systems of organisations, particularly in the procurement environment. Poor governance has, in the past, led to several major corporate collapses and, on a smaller scale, poor governance or inadequate internal control processes has resulted in fraud and pilferage. Although there are many avenues for organisations to reprimand the perpetrators, punishment is often insubstantial or nonexistent. This article investigates the factors fostering such fraudulent behaviour and the resources available for deterring these acts. It will also explore the various stages of procurement—contract planning, formation and management—and suggest how organisations can use procurement as a tool to improve governance.

Introduction

As organisations expand their businesses and networks, governance plays an even greater role in business activities. History reveals that many cases of corporate collapse are, arguably, caused by a failure of internal control and governance policies. Some of these prominent companies include Enron, Barings Bank and HIH Insurance (Leung & Cooper, 2003). Vinten (1998) suggests that the rise of corporate governance can be dated back to the nineteenth century when limited liability corporations started to emerge progressively and their failure and misuse of investors' funds became so rife that the need for legislation and regulation was subsequently triggered. Although the trend of corporate collapse is variable, such incidents still make the headlines because, as Barlow (2007: 61) believes:

While corporate compliance policies may define a finite number of rules to follow, crossing the line is limited to the capacity of our imaginations, the extent of our greed and the desire for the adrenaline rush.

Will corporate governance help to improve the situation? Although it is essentially a framework put in place to deal with the duties and responsibilities of a company's board of directors in managing the company and their relationships with the

shareholders of the company and the stakeholder groups' (Pass, 2004: 52), some organisations adopt the governance notion for different purposes. Mardjono (2005) suggests that organisations may recognise the need for a good corporate governance framework but then use the policies more as tools for *investor relations* purposes (as was the case with companies like Enron and HHH which adopted such a framework to heighten their stock prices for the benefit of their boards). Even when a framework is in place, organisations must investigate its adequacy and effectiveness as lack of enforcement is often the main cause of employee reluctance to follow rules (McC Campbell & Rood, 1997). Despite these mitigating factors, effective corporate governance is one of the key elements of business success.

Procurement, an essential business activity, is susceptible to corporate fraud and exposure to temptation exists for those operating in the procurement framework. Lander, Kimball and Martyn (2008) express concern over procurement fraud in the US Government and warn that such acts 'squander limited funds, threaten safety and national defence, cheat American taxpayers, and harms government efforts to obtain needed goods and services' (p. 18). Procurement fraud may go 'undetected, uninvestigated and unpublicised' (Durant, 2005: 30) because it often involves collusion. It goes uninvestigated because organisations are unaware that losses can be recovered. It goes unpublicised because such bad publicity only embarrasses management and dampens investor confidence. Due to these reasons, it is not surprising to learn from McC Campbell and Rood's survey (1997) that over 90 percent of those involved in 'misuse of position' (p. 1114) for private gains were never fully reprimanded for their actions.

Organisations can improve governance by ensuring that their rules and regulations address accountability, integrity, efficiency and transparency (Mardjono, 2005). The US Government Accountability Office (GAO) extends this framework and states that key characteristics of a successful procurement system include competition, organisational alignment and leadership, human capital management, and knowledge and information management (Barr, 2007). Furthermore, the systems have to be appropriately governed, regulated, imposed and enforced. This paper seeks to analyse these issues, and explores how procurement can be used to improve governance over competitive tendering and contracting.

This paper comprises four sections. First, it explores the factors influencing the fraudulent behaviour of individuals. The second section reviews some existing practices to improve governance and includes legislation, internal control systems of organisations and working relations between procurement agents and other professionals. A generic procurement framework is discussed in the third section and it will also be investigated how governance can be improved across different phases of procurement. The final section provides the conclusion and summarises the main aspects of the discussion.

Sources of Fraudulent Behaviour

Culture and Ethics

In today's cultural context, the ways in which ethics are taught is undergoing a revolution. As McCampbell and Rood (1997) suggest, 'values are something traditionally taught in the home, but with so much external influence, the home is not the only place where values are learned' (p. 1888). Through development and learning, individuals behave in ways that allow them to meet particular group requirements of the culture in which they are raised (Gray, 2003). However, what is acceptable in one culture may not be acceptable in another. A worst case scenario of this could be individuals unknowingly violating local laws when in foreign lands. For instance, an employee may accept gifts from a supplier if he or she comes from a country where bribery is common practice.

Due to the lack of 'global ethical standards' (Robbins *et al.*, 2001) organisations must develop and implement their own set of governance standards that adhere to local and international laws and contribute to the wellbeing of the society. However, while rules are there to guide the shareholders and employees, one cannot ensure that unethical practices will not occur. This is because most fraud cases are motivated by greed (Durant, 2005). Therefore, it is imperative that shareholders and employees exercise their due diligence and promote a working culture that encourages appropriate ethical conduct.

Competition

A competitive environment is widely regarded as providing the best chance of obtaining the greatest value in every business transaction. Hart (1983) states that a competitive environment gives managers less discretionary power and thus reduces opportunities to act in their own self-interest. However, competition may also lead to deviation from good governance principles. As Dignam (2005) suggests, 'the competitive environment in which companies operate is not acting as a disciplinary force on management' (p. 765). Furthermore, a survey conducted by McCampbell and Rood (1997) with government contracting personnel of the Defense Fuel Supply Centre in Virginia State showed that nine out of eleven personnel abused their authority in a competitive environment while two occurred under sole source conditions. The authors revealed that promoting competition can have undesirable consequences, especially when governance is not well enforced. Goods or services can be procured at better value in a competitive environment, but it does not necessarily mean that they are obtained from a fraud-free source.

Organisational Structure

With increasing globalisation, businesses are no longer constrained by national borders. Coupled with the aid of technologies such as the internet and computer network systems, organisations now find it easier to manage their business activities

remotely. This phenomenon creates two key changes to organisational structure. First, globalisation flattens the levels of hierarchy and increases the span of control of managers (Robbins *et al.*, 2000). Having a flatter hierarchical structure increases effectiveness and efficiency of vertical communication and speeds up decision making. However, as the span of control increases, managers have to spread their attention over a larger area. This trend inadvertently causes managers to compromise on the level of control over their business activities. Second, globalisation tends to shift to the decision making function from a centralised perspective towards decentralisation to promote faster responses to clients' needs. Distant staff now have greater discretionary power to decide on procurement matters. Both of these changes in organisational structure may encourage fraud. The US Special Commission on Army Contracting has uncovered 76 cases and charged 20 military civilian army employees with contract fraud in Iraq, Afghanistan and Kuwait operations (Army News Service, 2007). Although the number of impeachments is not alarmingly high, it aids to support the argument that globalisation does mitigate the effectiveness of control over business activities.

It is also essential to investigate the principal-agent¹ relationship in the procurement activity and identify inherent potential for conflicts within a company. Mardjono (2005) warns that 'the economic incentives faced by the agents are often different from those faced by the principals' (p. 274). A principal has a vested interest in the economic return of the organisation whereas an agent is more concerned with his or her duties within the organisation. It is unlikely that an agent will commit fraud on behalf of the organisation, but more likely for personal gain. Therefore, organisational rules and regulations must address the conduct of both the principals (in relation to stakeholders generally) and the agents.

Governance and Control Mechanisms

Legislations and Internal Control Systems

It is widely accepted that governments around the world implement laws and regulations to curb irresponsible business conduct. Numerous acts have been enacted and some of these have gained international recognition. For example, the *Sarbanes-Oxley Act* (SOX) was enacted by the US Congress in 2002 in response to accounting scandals at Enron, Worldcom, and related to other corporate collapses (Clarke, Dean & Oliver, 2003; Hilton, 2008). Although the focus of this act is to bring reform to company financial reporting processes (Hilton, 2008), it nonetheless also addresses the conduct of top management and other employees. When internal control systems fail to guard against fraudulent behaviours of top-management and employees, it may eventually affect the accuracy of financial reports. One internal control contained in SOX, related to procurement, is the establishment of authorisation levels for personnel making purchases of various types and value. Purchases that are of higher value require approval from appropriate personnel, as defined in the legislation.

Earlier, in 1984, the US Government enacted the *Federal Acquisition Regulation* (FAR) to improve the credibility of their arrangements between agencies and suppliers. This act states that all federal contracts worth over US\$5 million must include a clause requiring contractors to have a written code of business ethics. Companies also need to have an internal control system and an ethics awareness program for employees (Cable, 2007). Price is no longer the sole determining factor for huge contracts in the US.

To further prevent collusion of government officials and contractors, in 1988 the US enacted the *Procurement Integrity Act* (PIA). This act regulates the re-employment of government officials after they leave their government position. Furthermore, it prohibits illegitimate solicitation of procurement information, instils truthful declaration of re-employment by contractors and imposes a one-year ban for certain personnel on accepting compensation from contractors (Lander *et al.*, 2008). The US Government is attempting to use these various legislations to reinforce ethics and compliance requirements within companies to regulate their business activities. The latest version of the PIA aims to prevent unfair competitive advantage.

By and large, most organisations have internal control systems to regulate their business activities, protect their assets, minimise liability and ensure the reliability of their financial accounts. Hilton (2008) explains that an internal control system is designed to provide reasonable assurance to three key aspects. First, it helps to ensure that business operations are conducted in an effective and efficient manner. Internal control systems should not hinder operations but, rather, guide employees to operate within the designed framework. Second, it aims to improve the reliability of financial reporting by limiting the boundaries that promote unethical behaviour. For example, evaluation of tender bids often includes assessment of companies' financial standing. Unethical suppliers may distort financial reports so as to mislead members of the evaluation panel. Lastly, internal control systems help companies comply with laws and regulations. Investigations in the US conducted by the GAO uncovered unauthorised commitments and purchases from suppliers without a valid written contract (Barr, 2007), which was largely caused by ineffective internal control systems. With adequate internal control procedures that are rigorously applied, organisations can prevent major lapses such as procurement fraud, financial misrepresentation, corruption and unauthorised actions.

Procurement and Other Functions

Procurement is not an isolated field. Organisations do not procure products or services without having to satisfy organisational objectives. As such, it is inevitable that procurement agents interact with other professionals to secure the right goods or services at the right price. If the interaction is inadequate, the outcome can be disastrous. Procurement contracts that fail are often costly as organisations need to spend additional resources correcting mismatched purchases. According to James (1995), a well-constructed contract recognises 'the likelihood of disagreement between

the contracting parties and make[s] provision for disputes to be resolved in an agreed manner ...' (p. 386). Furthermore, with local and international legislation regulating business activities, procurement agents must work with other professionals to operate within the given framework so as not to violate laws and regulations unknowingly.

In order to obtain a favourable purchasing outcome, procurement agents have to utilise the expertise of legal advisers to develop contracts that offer remedies when mishaps occur. A well-constructed contract can offer three remedies. First, it can offer both buyer and seller an indemnity for outstanding commitments in the event of a breach of the contract by either party. Second, it allows companies to claim damages. Sweeney and O'Reilly (2001) believe that the purpose of an award for damages is to compensate the innocent party and not to punish the guilty party. With adequate provisions, the plaintiff can claim damages for those losses caused by the breach of contract. Lastly, it can limit or reduce the amount of damages to be paid in the event of a breach of contract.

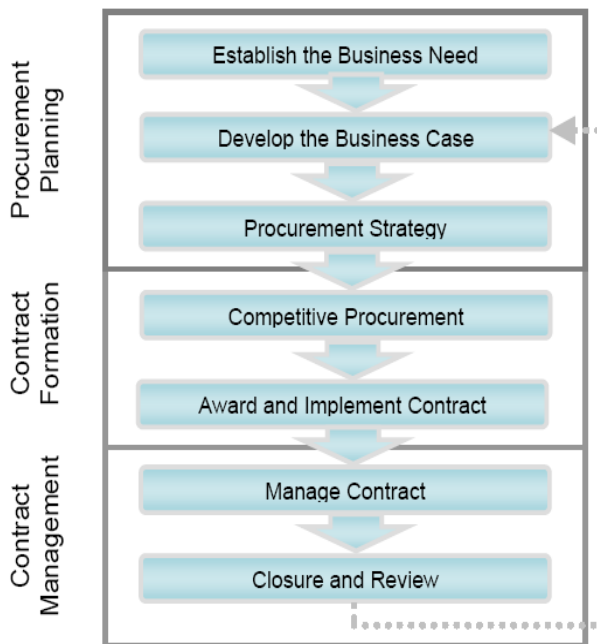
Auditors and other accountants can offer valuable assistance in tracking procurement fraud. Organisations usually have financial procedures that require procurement agents to obtain quotations from more than one supplier when procuring big ticket items. On the other hand, small ticket items can be approved without much difficulty. Such a degree of freedom, usually authorised to minimise procurement processing costs, allows procurement agents to make frequent and small purchases from their preferred suppliers as they can skip the usual requirement of obtaining additional quotations. However, these activities can be identified by tracking the number of small amount purchases of the same item within a short period. When such trends have been identified, the accountant can either seek explanation from a respective manager or alert higher management as an issue for investigation. This type of analysis, typically called a spend analysis, enables management to evaluate the precise nature of expenditure on all goods and services within a particular financial period.

Apart from legal advisers and accountants, procurement agents need to interact with end-users who are likely to be experts in their own professions. James (1995) warns that it is impossible for procurement agents 'to be competent in all sectors of industry... [as they] have the unenviable task of contracting for the supply of a wide range of products and services and may lose touch with many of them' (p. 61). Furthermore, they may be well versed in sourcing for suitable products or services, but may not necessarily be the best person to describe the specifications. Without tapping into the knowledge of the experts, organisations risk procuring products or services that are not fit for their intended use. When procurement agents and other professionals work collectively, they can improve contract success rate and prevent fraud.

The Procurement System

Procurement systems differ in every organisation. However, they generally include contract planning, formation and management and cover a vast array of activities ranging from the financial appraisal of the various options available to pricing, purchasing and administration of contracts (Lowe & Leiringer, 2006; DTF, 2008). The common procurement framework—promulgated by Department of Treasury and Finance for the public authorities—is shown in Figure 1. Aside from illustrating the sequence of events, the framework also suggests that procurement agents are constantly interacting with suppliers and contractors. Although fraud does not always occur in procurement, it nevertheless requires tight supervision as contractors or suppliers may entice shareholders and employees to support their agendas.

Figure 1: Procurement Framework



Source: DTF (2008: 11).

Lander *et al.* (2008) believe that anyone with the knowledge, opportunity and need can take advantage of the procurement process at any stage. For example, potential suppliers may attempt to offer bribes to procurement agents to gain confidential information that will put them in a favourable position against their competitors. Such undesirable behaviour may continue even after award of a tender. The risk of fraud and collusion escalates more as procurement agents or managers are working increasingly alongside contractor personnel in a ‘mixed workplace’ (Weigelt, 2007: 58).

For instance, incumbent suppliers or contractors may collaborate with procurement agents in order to reduce their costs or seek additional sales. Therefore, it is vital to protect the integrity of a tendering and contracting framework, and enforce governance across all levels of the procurement process.

Contract Planning Phase

Business needs are identified at the contract planning phase (Storey, 2005). Without a business need, there is no necessity to procure products or services. However, how can one differentiate between business need and a personal need? More importantly, how can organisations prevent their agents from making personal gains at their expense? For example, while procuring a fleet of vehicles for the organisation, an agent can request that the supplier extend the same offer (discounted rate for fleet purchase) for his/her personal use. Although such actions may seem harmless to the organisation, the buyer or supplier may distort the tender evaluation so that the desired outcome is achieved. Secret payments or kickbacks offered by the supplier may not be transacted at a workplace, thereby increasing the difficulty of tracking such collusive acts. Furthermore, since contract planning and award occur at different phases—contract planning is at the preliminary stage of the procurement process—it will not be easy to associate the final outcome (award of tender) with the principal or the agent (staff member).

The behaviour of procurement agents, as employees, is governed by state laws and, thus, an agent must be found guilty before punishment can be set. By that time it may be too late for any recourse and organisations may choose to conceal the incident in lieu of bad publicity. McCampbell and Rood (1997) have noted that many violators receive no punishment at all. This type or lack of response to violations makes it difficult for management to maintain an ethical workforce. Therefore, it is advisable for organisations to appoint senior officers—preferably those governed by corporate responsibility as such personnel are required to exercise a higher degree of care and diligence—to approve major purchasing requirements and all procurement policy before executing the purchase. For instance, Department of Treasury and Finance (2008) recommends procurement agents develop business cases for purchases that are high risk, high value or of a unique nature. Such business cases are to be endorsed by appropriate forum, such as a State Tender Review Committee.

Procurement agents must be able to identify risks associated with different procurement methods. Lander *et al.* (2008) suggest that procurement can be carried out through competitive bidding, negotiations or sole sourcing. A much earlier view from Hart (1983) showed that competition limited the discretionary power of managers and reduced opportunities to commit fraud. However, greed seems to have the ability to evolve and subsequent reports from McCampbell and Rood (1997) and Dignam (2005) suggest that agents in competitive environments are more susceptible to bribes. More frauds are also exposed in a competitive environment than in sole sourcing situations. Yet the GAO, while reviewing the procurement system in the District of

Columbia, noticed that common procurement lapses in contracting operations arise from ineffective competition and from overuse and misuse of sole sourcing contract awards (Barr, 2007). Although there are contradicting views on the degree of unethical behaviour between competitive bidding and sole sourcing, it seems that the problem inherently lies with individuals rather than different procurement methods.

Effective tender specifications are vital in the facilitation of an unbiased tender evaluation. James (1995) recommends avoiding discrimination against any particular source of supply or contractor. Specifications that are prepared in favour of a particular source limit the pool of supplier or contractor. For example, instead of listing the brand and model of the desired product, procurement agents can simply specify performance indicators such as speed, torque or horsepower. This method will enable vendors with suitable products to participate in the bid.

Contract Formation Phase

The contract formation phase of competitive tendering involves: an invitation to quote, tender evaluation and award (DTF, 2008). Sealed bids must be handled with care to ensure that security and confidentiality are maintained. Organisations need to devise internal control procedures to facilitate the collection of these documents. The Department of Treasury and Finance (2008) recommends having two supervising staff to witness the opening of tender bids. This can help prevent collusion between suppliers and employees. For example, if an employee is conspiring with a supplier, he/she may leak bidding information and subsequently accept the late bid submitted by the supplier. This is not likely to occur if there are two supervising staff to oversee the process (unless, of course, they collude) especially if they are not directly involved in the bid.

Organisations have to assess members of the tender evaluation panel to ensure that there is no conflict of interest. Durant (2005) observes that fraudulent collusion usually occurs either between members of staff or between members of staff and suppliers. However, ill-informed staff may get themselves into trouble when their organisation discovers their relationship with a supplier. Even when there is no fraudulent activity between both parties, the organisation may choose to redeploy the staff or change supplier to deter any possible collusion that may arise in the future. Thus, as Durant suggests, all procurement agents should report any potential conflicts of interest on an annual basis.

As well as collusion, failure to enforce stringent procurement policies also encourages fraud. Effective procurement policies should clearly set out what is permissible and what is against company policy. In addition, organisations need to ensure that their employees understand the rules and regulations. With informed guidelines, employees involved cannot claim ignorance if their actions were against company policy. In addition, it is advisable for members of evaluation panels to declare any possible conflict of interest at every new tender evaluation.

Organisations can take proactive steps to prevent fraud. In the aviation industry reporting culture is a vital component of safety. A reporting culture fosters an organisational climate in which people are prepared to report their errors and near-misses. However, encouraging staff to step up and report will not be easy if there is no organisational system to facilitate the communication. Reason (2006: 197) suggests five factors that can help to create a climate of trust and motivate people to file reports. They are:

- *Indemnity against disciplinary proceedings—as far as it is practicable.*
- *Confidentiality or de-identification.*
- *The separation of the department collecting and analysing the reports from those bodies with the authority to institute corrective actions.*
- *Rapid, useful, accessible and intelligible feedback to the reporting community.*
- *Ease of making the report.*

Negotiations are often necessary to ensure that requirements of the tender bid are understood by the supplier. It offers a more flexible way of contracting but also provides the contractor a greater degree of freedom to develop the procurement proposal and an opportunity to sway the procurement agent to pay higher prices (Lander *et al.*, 2008: 18). Negotiation should not be uneven but, rather, help both parties achieve a win-win situation. James (1995) states that ‘ethical conduct demands that competitive prices are not divulged nor information passed to the bidders that will provide knowledge of competing bids’ (p. 236). Once the decision is made, both the successful and unsuccessful tenderers should be notified. James continues on to suggest that the successful tenderer must be informed first, followed by unsuccessful tenderers, allowing for further negotiations to take place if the selected bidder rejects the offer.

As negotiation involves interaction, suppliers may take the opportunity to throw in so-called freebies to entice the panel to award the contracts in their favour. Such perks may include first-class travel to visit plants, free gifts or even lavish entertainment. However, tender evaluations and negotiations should be held in an objective manner and decisions should not be swayed by unscrupulous tactics employed by the suppliers. Furthermore, McCampbell and Rood (1997) warn that procurement agents may use their positions for personal gain by promising favourable treatment during negotiations.

Contract Management Phase

Contract management includes the managing of day-to-day operations. The contract now serves as a guide for managing procurement staff. Due to the dynamic nature of operations, many variations can occur. Therefore, it is important to note that the contract has to be a live document. Instead of following the terms of contract

religiously, managing staff must be able to identify areas of improvement in their respective fields and recommend amendments be made to their contracts whenever feasible. These amendments must be studied and agreed upon by appropriate individuals such as engineers, lawyers or other relevant professionals.

Yet when contracts become flexible, collusive behaviours may arise. As managing staff are in constant contact with contractors, they are vulnerable to bribes or kickbacks. Such activities are even more difficult to identify if the culprits are total strangers to each other—where there is no obvious sign of conflict of interest. In addition, procurement agents may also use coercive management styles to seek personal gain since contractors may abide in exchange for favourable treatment. It results in a win-win situation, though in a dishonest way, for both parties. For this reason, many such cases may go undetected. In order to rectify these situations, business processes must include check-and-balance formulas to detect both discrepancies in deliverance of contracted goods or services and unethical behaviour.

In every profitable contract, the priority of the contractor is to secure the renewal of the contract and, if possible, secure the contract in a non-competitive environment. Barr (2007) warns that ‘failure[s] to conduct advance planning for known projects and procurement requirements lead to costly acquisitions that are often based on faulty justifications’ (p. 9). To avoid such situations, the management will need to focus on several key issues. First, both contractor and client may have established a cordial relationship which influences the client to extend the contract instead of calling for a new tender. Second, after spending so much effort dealing with and coaching the incumbent to work within the client’s framework, the client may not wish to repeat the process with a new supplier. Third, collusion between the contractor and client may occur when the client decides to call for a new tender. It is important to ensure that the client does not over-rely on the contractor’s expertise to draft the specifications. Although seeking incumbents’ expertise seems sensible, it may cause the specifications to be written in their favour which will, eventually, limit the competitiveness of the next tender.

Conclusion

In summary, procurement can be used as a tool to aid organisations in governing their business activities. While governments, regulatory institutions and organisations have the power to enforce rules and regulations, they are not able to eliminate fraud entirely. This is because fraud is largely motivated by greed and because individuals are still capable of committing procurement fraud even when rules and regulations are in place. In order to improve governance, organisations must adopt a holistic approach which includes not only implementing rules and regulations, but also addressing factors that promote fraudulent behaviour. Much procurement fraud goes undetected, uninvestigated and unpublicised. For those caught, there is still a chance to escape punishment as, in the majority of cases, full penalties are not delivered. Such a loose

management approach not only encourages procurement fraud but also puts organisations' reputations at stake. More organisational intervention is needed.

Procurement agents may be well versed in sourcing, but they need to tap into the expertise of other professionals in order to improve contract success rates and governance. Professionals (end-users) provide valuable input to the construction of specifications and, thereby, improve the likelihood of procuring the right product at the right price. Organisations can also save time and resources by avoiding mismatched purchases. In addition, legal advisers, internal auditors and accountants provide valuable support in improving governance. Without their assistance, organisations may have difficulty identifying the culprits, enforcing rules and regulations and gaining control over their business activities. Seeking support from other professionals can improve these conditions and ultimately shrink the perimeters within which procurement fraud can occur.

Procurement can be an effective governance tool provided watertight procedures, rules and regulations are put in place across all levels of the tendering and contracting process. Organisations must have robust audit systems and need to test them constantly. Frequent checks on procurement activity can help mitigate and prevent procurement fraud. Ethics awareness programs—requirement of FAR—keep employees informed of business ethics and various punishments for non-conforming behaviour. Such programs refresh employees' memories and reiterate the consequences of committing fraud. To improve governance, organisations will have to adopt laws governing their business activities and incorporate key requirements into their ethics awareness programs. Some of the common laws include, but are not limited to, existing corporations legislation and, where applicable, laws such as FAR and SOX. Furthermore, it is recommended that organisations incorporate these key requirements into their business practices. With increasing demand for governance, organisations need to review their procurement processes and utilise procurement as a tool to regulate the conduct of both stakeholders and employees.

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Notes

- 1 Principals are owners of the companies and own the net income of a company's business. Agents are those who execute their duties and responsibilities within the companies on behalf of the principals. These terms are used throughout the paper for clarity, even though the term *procurement agent* is only used in some jurisdictions.