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### **The Insulator Factor**

Contracts tendered and accepted anywhere in the world usually must have an insulator factor or inducement, agreed too openly or covertly. The type of industry involved and whether they are dealing with the public or private sector will determine the size of the inducement to get a contract signed and delivered. The one underlying factor that always shows an inducement is the cost of the contract compared to market value.

### **The Loser Is . . .**

Looking through various industries it is very easy to get this point sector by sector by the very tendering process itself. Has the supplier been dealing with the same firm or government for a long period of time? This is always a sign that that long term business relationships are becoming incestuous. The long term loser being the consumer or taxpayer.

### **Size Of The Inducement Factor**

How big is the inducement factor in Contract Tendering? I once commented to a Revenue Canada Investigator that any item on the grocery shelf has a built in inducement of about 30 percent of the value of the product on the shelf. His reply was that it is really 35 percent. On this topic when you price out store brands which are usually manufactured by the brand names, store brands are about 30 percent to 35 percent less expensive than the brand names. What makes up the difference? Marketing allowance, shelf space allotment and just plain old payola. Somehow, the insulator costs have to be covered and it always goes in the price.

### **Some Countries Call It Bribes**

I call this an insulator or inducement, but in some countries they just call it a bribes, kickbacks and graft. This goes on in every area but in some jurisdictions it is more open than others. The horror stories that have taken place in this area are absolutely unbelievable but always predictable and usually always there.

## **The Private Sector**

The private sector has its own insulating factor in just about every industry. What encourages this type of dealing is any economic sector that has limited competition. The dominant players in any industry like this usually have a prescribed list of goodies to induce sales and contracts. While society views this for the most part as a victimless non-violent crime, make no mistake that money, houses, personal property and lives are virtually brought to a standstill because of this.

In the end this is not just a secret commission but a complicated form of fraud and I would suggest that it is not only the purchaser of the goods, but all of society that pays the price.

## **Prosecution Is Rare**

Criminal Prosecutions in this area are rare. Why? This is due to fact that it touches on just about every walk of life and is perceived as normal business in most areas which is a mistake since as time has move don the medium for which I am writing this coupled with government taxation has made this practice even more obscure.\\Take any corporation with a marketing, accounting and procurement department and the possibilities are endless.

## **Even Small Companies**

It does not even have to be a very big company to get this happening. The construction business is a legend for this type of thing and when it is obvious that once contractor is favored over the others and has always got the same business all of the time, then once the price is checked there has to be a reason.

## **One Example**

One contractor has petty cash disbursements of \$2000.00 per week and the same bundle of customers. So guess what? They were also able to do \$250,000 jobs that included a cost overrun of \$100,000. That's right on a job like that the insulator factor was incredible. The contractor worked extensively for a city that was less than secretive about how contracts were awarded. This is happens in Canada extensively.

## **During An Election**

Want to hear something even more unbelievable? As this was a municipal government matter during an election the paper on this project was obtained and when this was brought up to the Municipal Administrator and elected officials. There was never an answer. Tragic, but true.

## **Flawed Tenders**

What was happening was the sealed tender process was totally flawed and the contractor has the bids custom written so nobody else could qualify. The term “Unique Construction” was used to justify the cost bulge. One of the very easy signs that the sham is on in an administrative structure, is when you have people that do not take holidays or time off. They have to guard their operations slavishly and ward off anything new or inquisitive. Why wouldn't a lot of this product be picked up at audit time? Simply because the accounting function has picked the auditors and written the terms of engagement for the auditors.

### **Dealing With Vendors**

Marketing deals with the electronic media business are real cute, usually through government regulation the competition is small and the prices expensive. Selling marketing or dealing with those that are vendors for media is always a very fast business. The insulator factor here is obscene. There are more hands in the pie than is imaginable and media outlets have never been shy about supplying whatever to get a contract. This could include dinners, tickets to sporting events, trips, gift certificates or just cold hard cash.

### **Procurement Departments**

Procurement departments are absolutely notorious for engaging in this type of activity. The insulator factor here is as far as the eye can see and as arrogant. Food and beverage related manufactures and distributors are always delightful. In this arena the insulator factor takes on words like “Buyer Premiums” or “Seasonal Promotions” but make no mistake it is just plain old payola.

### **The V.P. Who Just Kept Taking**

A V.P. of procurement for a medium size restaurant chain making a salary in the high five figure bracket lived like somebody in the mid six figure bracket. What gave it away to start with was the price of goods purchased compared to market value and his selection of toys and treats.

### **He Had A Nice House**

His new house built at the time that the cost of goods to the restaurants visited the stratosphere would have cost conservatively \$600,000.00 and that is not accounting for his art collection. The picture below is of his house and was built by him while making about \$80,000.00 per year including benefits and lives in a very prestigious area. When the builder of the house was contacted he openly said “It was obvious he came into money after he started building the house” The builder received over \$200,000 in cash towards the construction and in addition a \$250,000 mortgage was taken out against the title. Not bad on this salary! Once again this was by no means hidden with many

people in the corporate headquarters talking about the tile and marble from Italy and the rugs being brought in from India. This is a view of the front of the house:



The house closest is a view of the back of the house and note the lot size.

### **His Clothing Allowance**

Further inquiries revealed that he had a clothing bill from on the up-scale men's stores of about \$1500.00 per month. He even had his own private advisor in the store to advise him of what to wear at what function. Let's not forget the weekly hair trim and manicure. After all, what that amount of insulator you have to look good at your daily supper. Not bad for a high five figure salary.

### **He Resigned. . .**

This gets better, after some 70 odd price hikes over the seven month period and many of the franchisees in the chain unable to pay their bills he resigned and went to work for the chain's one and only distributor.

### **Devastating Results**

The price carnage continued with the end result being 30 restaurants closed and franchisees bankrupt or defaulted out of the system. We are not finished yet! The distributor where he worked had been the chief supplier of most of the payola in this plot and we even found a couple of houseboats on a lake in Arizona. The boats were appropriately named after the distribution company.

### **Franchisees Got Smart**

In the end a group of the franchisees began looking into the pricing of distribution and found that the prices were actually 35 percent above market value. Here was the insulator factor and when forced to be competitive, the distribution company went bankrupt. The company president who knew about this was quick to allow breaches of procurement policy to placate the franchisees as the president had been confronted with the house.

### **\$6.5 Million Dollar Loss**

Not before the new owners were bilked out of \$6.5 Million dollars. About a year, after this all took place one of the franchisees got behind in payments to the restaurant chain for royalties, advertising and rent.

### **The Lawyer Backed Off**

Just when he was about to be kicked out of the system he mentioned this to his lawyer who in turn told the chain lawyer that he was making an application for a court injunction based on the bribes and kickbacks. The result was the chain's lawyer suddenly becoming agreeable and the termination of the franchisee was withdrawn. One of the players in this situation is the Director of Procurement with another medium sized restaurant chain and yes, the menu prices are hefty. The restaurant chain is still bankrupting franchisees at a record rate and by the end of 2003 over half of the chains franchise owners were not making their payments as per their agreements. The cost of sales had increased substantially!

### **The Public Sector**

Now that we have seen a small smattering the private sector, let's move to the government sector. Governments of all levels, whether it be municipal, regional, provincial or federal all have their own set of problems in this area. The administrative

management level of any of these governments make the private sector players look like extremely poor cousins. They grin and wink, do a few favor for their elected masters and voila! The cookie jar is wide open. We have a day of coffee lunch coffee a big salary and insulator factor opportunities that are absolutely obscene.

### **The Community Planner**

Take a planner in a small municipality who seems completely normal. A well known builder in the same municipality can get authority to build when other contractors have trouble. The difference was that the builder had built the planners house and when you go look at the house, you can see what went on.

### **Look What He Got**

The planner probably had about \$40,000 in gravel and preparation work for his house and without getting into this too deep; it was obvious the builder had the run of the land. This came to my attention when a client complained that he could not get a building permit virtually across the street from where the builder had got a permit. In the end, the client did not want to waste the time and money to get into this any deeper.

### **Cost Overruns**

Take any construction project initiated by any level of government and the next words you will hear are cost overrun and in this area 100 and 200 percent overruns are not unheard of. What makes governments to hard to track down in this area is that there is so many cost overruns that it is hard to keep up to.

### **No Sealed Tender Process**

One municipality I know of does not have a sealed tender process and people bidding on work usually try to get the bid in at the last moment, otherwise they will lose the bid for sure as they will be undercut by everybody that submits a bid after. I can get into the other levels of government, but what makes the municipal governments unique is that their adventures don't appear on the nightly news as do the provincial and federal governments.

### **The Penalties Are Small**

Once again charges preferred for receiving secret commission are rare because of their perception with the public. I say the penalties for this should be huge since the damage here is attached to your tax bill. How do we get out of this type of situation? It is very complex due to the push and pull of different levels and jurisdictions. Some are of the opinion that in North America, we are very small in relation to the rest of the world. We are just as bad as the rest of the world only here, it is more hidden and every bit as expensive.

## **What Government Should Be Doing**

One thing that governments could do is alleviate this to have independent contractors both preparing the tenders and comparing them with the end based on cost. As long as you have somebody paid that can get away with a high price you will always have this. With the private sector, there has to be competition in every sector of the economy and governments cannot be shy about asserting their position in promoting a market place.

## **The Key Is Public**

This is the key here in that a market place is public policy and not private policies as some corporations seem to think. The other factor is that the Income Tax People have to be more vigilant in checking the flow of currency for this would make it both tough on both the private and public sector participants. Currently there is very little done to stem the flow of currency and very few questions are ever asked about it.

## **Stem The Flow Of Money**

To deter the insulator factor some of what I have suggested would have to be implemented and I think the biggest factor would be stemming the flow of money. The other that always works in any democratic country with problems is disclosure and education. Right now this process would not raise many eyebrows, but if it were disclosed properly to the media, things would soon change. If ethics in this area were a topic for all concerned, gradually the price of goods would subside and the enormous pressure on taxation would ease.

## **I Have Seen A Lot Of This**

Having been involved in quite a few of these situations where the insulator factor is present, and the price of product out of line, the other easy way to tell that this is going on, is to look at the receipt of the goods. Anyone in a position either public or private, to do favors or receive them is a candidate and this is where a thorough asset check comes in. The recipients can hardly contain their glee and feelings of superiority. What they do is look like is a clown advertising for the vendor that now owns them. That comfort zone of lifestyle is easy to see and find.

## **Showing The Toys Off**

Let's face it, when you have the toys you have to flaunt them. That new vehicle, boat or vacation property deserve some good office talk.

## **We Are A Democratic Society**

In a democratic society, the one thing that always brings change is disclosure and media attention. If the cost of this both public and private was constantly revealed eventually there would be structural changes in administrations if not meaningful legislation to guard the public from this type of things. This is a huge economic problem and as time passes the importance of a remedy here will soon become evident.

This article was originally written in 1999 but now in 2004 with sponsorship, contracting scandals rampant in Ottawa nothing has changed it has just become more blatant and obvious.