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Contract Splitting: What Board of Directors and Senior Management Should Look Out For

August 2025 | Corporate Fraud Series | KPMG Forensic in West Africa

Overview of contract splitting

Procurement fraud is the unlawful manipulation of the process of acquiring goods or services, to obtain an unfair advantage[1]. This type of fraud can occur at various stages of the procurement cycle, i.e., tendering, purchasing, contract execution and payment.

Contract splitting is one of the most common types of procurement fraud. It involves instances where a large contract or procurement is broken down into smaller segments to avoid triggering specific approval thresholds, that would require scrutiny by the Board and/or Senior Management.

By fragmenting the total value of a contract into smaller parts, the individuals responsible for procurement or project management can bypass higher-level approvals, which might have otherwise imposed more rigorous evaluation, resulted in competitive bidding, or additional oversight[2].

Contract splitting is also referred to as **'split purchase'**, **'split transaction'**, **'cost splitting'**, **'bid splitting'**, **'tender splitting'**, among others.

Why the Board of Directors and Senior Management should be concerned

Contract splitting presents the following risks to the Board of Directors[3]:

1. **Governance failure**

   The Board of Directors is responsible for ensuring that the Company adheres to legal and ethical standards. Contract splitting may not provide the opportunity to the Board to carry out its oversight function over the efficient utilisation of the Company's resources and may adversely impact the Board's fiduciary responsibilities.

2. **Higher costs**

   Where contract splitting is prevalent within a Company, the Company may end up incurring higher transaction costs, including:
   a) Added project costs.
   b) Administrative costs.
   c) Regulatory fines.

3. **Government and regulatory risk**

   Where the contract is split to circumvent regulatory thresholds or competitive bidding, it may attract the attention of regulators, auditors and investigative bodies, leading to unnecessary investigations and potential regulatory actions.

[1] Source - Certified Public Accountant (CPA) Handbook on Fraud
[2] Source - Association of Certified Fraud Examiners (ACFE)
[3] Source - Organisation for Economic Co-operation and Development (OECD) Guidelines

4. Symptoms of other forms of procurement fraud

Contract splitting may be a strong indication that other forms of procurement fraud exist i.e. bribes and kickbacks, change order/variation abuse, collusive bidding, conflict of interest, among others.

Signs your Company is falling victim to contract splitting

Some of the indicators of contract splitting in a Company are[4]:

1. **Similar procurements from the same supplier**

   Two or more similar procurements with the same supplier (and or related entities) in amounts just under competitive bidding or senior management level review limits.

2. **Fragmented project phases**

   Projects that could logically be bundled into a single contract, but are instead split into multiple contracts or separate phases. For example, separate contracts for labor and materials, each of which is below competitive bidding limits, but when combined is over such limits.

3. **Regular modification to contracts**

   Instances where frequent amendments or adjustments are made to smaller contracts over time (such as adding more work or extending deadlines), indicate that larger projects may have been artificially split. This also involves contracts under the competitive bid limit followed by change orders that increase the amounts of the contract.

4. **Contract with sequential purchase orders issued to the same or related vendors**

   This involves consecutive purchase orders that fall just under competitive bidding limits or senior management level review, and are issued to the same/related contractor or for the same project.

5. **Unusual contract timing**

   Contracts awarded in rapid succession, particularly at the end of the fiscal year or reporting period, with a follow-up contract issued at the beginning of a fiscal year or reporting period.

[4] Source - International Anti-Corruption Resource Center (IACRC), ACFE, OECD Guidelines

How can the Board control and mitigate contract splitting?

The best practices and principles for the procurement process to mitigate risks emanating from contract splitting include the following[5]:

1. **Tone at the Top**

   Board members should set the tone at the top by ensuring that procurement involving related parties are disclosed and monitored.

2. **Clear and comprehensive procurement policies**

   The Board should ensure that the Company has clear and comprehensive procurement policies that comply with relevant laws and regulations. These policies should specifically address the prohibition of contract splitting and establish clear controls/procedures for procurement that require transparent, competitive and fair bidding processes.

3. **Strong Internal Controls and Monitoring Mechanisms**

   Implement Strong Internal Controls and Monitoring Mechanisms to oversee procurement activities regularly.

   This could include:

   a. Regular review of procurement reports to provide a consolidated view of the Company's procurement processes.

   b. Periodic audits.

   c. Reviews of contracts, account reconciliation

   d. Automated checks to identify any instances of contract splitting.

   As a part of this, the Board can request for periodic reports on global view of contracts issued per:

   a. Vendor.

   b. Contractor group (related vendors), etc.

4. **Whistleblower and Reporting Mechanisms**

   Establish anonymous whistleblower mechanisms that encourage employees, suppliers, and contractors to report suspicions of contract splitting or other procurement irregularities, without fear of retaliation. Also, address complaints from potential suppliers in a fair and timely manner.

5. **Training and Awareness Programs**

   Ensure that regular workshops on compliance, anti-corruption, and procurement best practices are conducted. Procurement teams should equally be trained to recognise and report signs of contract splitting and conduct refresher courses to stay up to date with changes in procurement laws and practices.

[5] Source – OECD Guidelines

Case studies on contract splitting fraud

Case Study 1

An in-depth analysis of the procurement records of Company A identified vendors, who provided related services on several individual projects. The procurement officers deliberately split a contract for a particular project into smaller contracts and awarded them to the multiple vendors. An analysis of the vendor database revealed that the vendors to which the contracts were awarded to were related entities who provide similar services and share the same contact persons albeit different contact information.

By splitting the contracts, the procurement officers, as well as the related vendors were able to bypass internal approval thresholds and avoid oversight by senior management. Additionally, the Company also incurred higher procurement costs as a result of operational and administrative costs of the split contracts.

Case Study 2

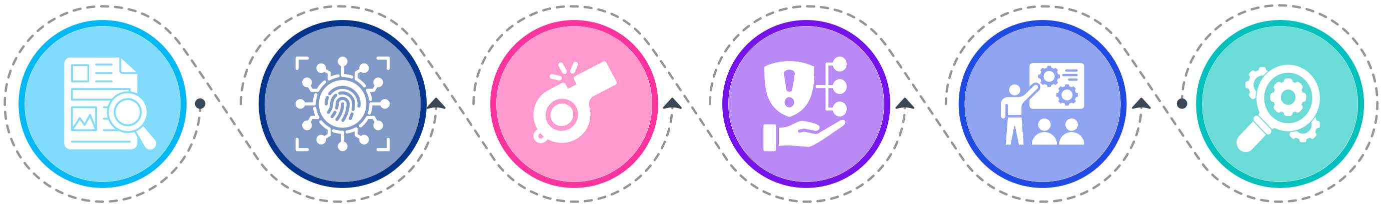
A review of the procurement records of Company B indicated various instances where contractors were selected for contract awards outside the competitive bidding system and without the approval of the senior management. The cumulative value of the individual contracts was significant; however, the procurement system was exploited through strategic contract splitting such that a particular project was broken down into smaller related contracts. The individual values of the split contracts were relatively insignificant compared to the cumulative value of the project, making it easier to bypass the approval process.

This further resulted in higher project costs due to fragmented contract phases, and opportunities for bribe, kickbacks and collusion with preferred vendors. There was also little to no oversight by senior management due to the fragmented low-value contracts.

By addressing the risks associated with contract splitting proactively, Boards can ensure that their Companies remain compliant, ethical, and resilient in the face of the many existing governance challenges.

How can KPMG assist

At KPMG, we offer a selected range of services aimed at assisting clients to combat corporate fraud.
The coverage/focal areas include:



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