

A CHIEF PROCUREMENT OFFICER'S GUIDE

CONTRACT COMPLIANCE AUDITS



Introduction

As a modern procurement leader, you have many responsibilities. As part of your expanding role, you must confront rapid change and market uncertainty. You must evolve, innovate, and optimize. And most of all, you must capture opportunities for creating and driving value.

In today's environment, this journey entails keeping cost reduction and risk management as top priorities. But, this must be done while also looking to new market expansion and continued product development, increasing cash flow, expanding via acquisition, and increasing capital expenditures.

Procurement leaders have taken note.

In fact, a 2017 Deloitte Global Chief Procurement Officer Survey,* which captured feedback from 480 procurement leaders in 36 countries, found that these are the top priorities for CPOs.

However, the world of procurement is filled with competing priorities and objectives that are often pushed aside due to resource limitations, day-to-day fire drills, and other internal challenges.

To make progress in addressing this year's key CPO priorities, you need help.

PERCENT OF CPOS MAKING THIS A "STRONG PRIORITY"	
Cost Reduction	79%
Managing Risks	57%
New Market/Product Development	52%
Increasing Cash Flow	48%
Expanding by Acquisition	21%

In this guide, we explore how independent contract compliance audits can help you more effectively address each top CPO priority, thereby reducing costs and risk while significantly driving organizational value.

*The Deloitte survey was conducted in association with Odgers Berndtson. It asked procurement leaders about key themes and challenges facing the procurement function, including market dynamics, value delivery, collaboration, digital procurement, and talent. Responses were received from procurement leaders representing organizations with a combined annual turnover of \$4.9 trillion.

Table of Contents



**A Brief Primer on
the Function and
Process of Contract
Compliance Audits**

1



**Priority 1:
Sustaining Cost
Reduction and
Increasing Cash
Flow**

4



**Priority 2:
Managing Risk with
Transparency and
Trust**

7



**Priority 3:
Expanding into
New Markets with
Communication and
Performance**

8



**Priority 4:
Expanding by
Acquisition with
Consistency and
Clarity**

11



**Priority 5:
Increasing Capital
Expenditures with
Dependability and
Transparency**

14



**Contract
Compliance:
Common Questions
and Confusions**

16



**Next Steps:
Engaging a Third
Party Auditor**

19



A Brief Primer on Contract Compliance Audits

From procurement to finance to the business, contract compliance audits can benefit the many functions of your organization. But, what exactly are contract compliance audits? And, are they right for you and your organization?

Let's find out.

The Purpose and Key Benefits of a Contract Compliance Audit

The core function of a contract compliance audit is to ensure that the performance and invoices of your third parties align with your contractual agreements.

However, high-quality audits can also be valuable tools for enhancing transparency, efficiency, and accountability. Further, they can help establish more productive relationships by strengthening and clarifying contract language and improving communication between the parties.

In addition, contract compliance audits can help you identify and recover lost profits, verify data reported by third parties, and assess the effectiveness of related internal controls and processes.

If these outcomes appeal to you, there is good reason: Ongoing and periodic audits can aid the efforts of procurement leaders in nearly any industry.

Understanding the Process: A Sample Audit

To fully understand a contract compliance audit in action, imagine that your organization is building a new structure, such as a warehouse, factory, office building, or data center. During the construction phase, contract compliance audits can be performed at the midpoint and conclusion of the project to validate that the costs you've incurred are authorized and charged in accordance with the terms of your agreements.

Construction contracts typically require general contractors and subcontractors to keep records of all labor, materials, equipment, and other costs incurred to

complete the project. During the audit, these records may be requested for review. This level of detail and documentation is often not provided to project stakeholders during the normal course of business, so there is a real risk they are not seeing the full picture when approving invoices for payment.

The auditors become acquainted with the history of the project, roles, and responsibilities of the project team, and potential risks. Working together, the auditors and project stakeholders identify opportunities to mitigate overcharges and excess spending. The audit findings are then summarized in a report and presented to management, followed by a meeting to discuss the observations, contractor's responses, remedies, and recommendations to mitigate risks and strengthen controls going forward.

Employing Contract Compliance Audits to Address Key CPO Priorities

While construction projects provide just one example of the benefits of contract compliance audits, procurement leaders have discovered that audits of a wide range of spend categories can yield similar results.

In the following sections, we explore these benefits, each aligned to one or more top CPO priorities.





Priority 1

Sustaining Cost Reduction and Increasing Cash Flow

It is no surprise that cost reduction remained a top CPO priority in the 2017 survey results. With increases in operating costs and competition across almost every industry, nearly 80 percent of CPOs surveyed say cost reduction will be a “strong priority” over the next 12 months.

While the focus on cost reduction reflects larger corporate trends, it is also a direct result of the importance of contracts in procurement.

Organizations rely on third parties, so contracts are critical to defining relationship terms and outlining responsibilities, deliverables, and compensation. Procurement leaders are the stewards of these agreements and they dedicate significant time, energy, and resources to negotiating the best possible terms.

However, during contract performance, even the most skilled and vigilant stakeholders can overlook inadvertent noncompliance.

A contract compliance audit can aid in achieving cost-cutting objectives by not only ensuring that contract terms and conditions are met, but also uncovering overpayments or under-reported revenue, unrecorded liabilities, and missed savings. The result is increased cash flow. Nearly 50 percent of CPOs surveyed stated that increasing cash flow is one of their top priorities this year.

With audits typically identifying noncompliance totaling 2 to 4 percent of the transaction value audited, savings and cash recoveries can quickly add up—especially with larger, multi-year contracts.

In addition, a contract compliance audit can provide a unique opportunity to assess third party data for insights and intelligence that can be used to implement process improvements.



12 Common Issues That Generate Cost Recoveries



**Over-Billed Rates,
Unit Prices, or Taxes**



**Excess Mark-Ups
and Margins**



**Unrealized Rebates
and Incentives**



**Verbal and Non-Binding
Agreements**



**Failure to Pass Through
Discounts**



**Understated Sales /
Underpaid Royalties**



**Noncompliant
Subcontracting**



**Overstated
Costs**



**Media
Credits**



**Related Party
Transactions**



**End-of-Fiscal-
Period Prepayments**



**Noncompliance with
T&E Reimbursement**



Priority 2

Managing Risk with Transparency and Trust



Procurement leaders are also focused on reducing risk, likely the result of continued increases in financial, operational, and reputational risks across industries. In fact, the number of CPOs who view managing third-party risks as a top priority has risen by nearly 20 percent since 2014.

Key factors in reducing risk are communication, transparency, and trust between companies and their third parties. A contract compliance audit can improve each of these, promoting communication and yielding the collaboration needed to reduce friction, waste, poor quality, and turnover.

Risk Reduction Factors



Communication



Transparency



Trust

Contract compliance audits are particularly valuable when you have third-party relationships with signs of high risk, such as:

**YOUR
CONTRACT
TERMS ARE
COMPLEX.**

With the intricate nature of some contracts, compensation methodologies, and pass-through practices, an audit can ensure compliance with terms and the use of effective operating procedures. Further, they can strengthen third-party relationships and help clarify complex contract terms on large projects.

**THE THIRD
PARTY HAS
OPERATIONAL
CHALLENGES.**

If your third party is not meeting operational objectives such as KPIs and SLAs, pricing compliance may also be lacking. An audit can help identify root causes of the operational challenges and contribute to improved operations, adding to the value of any noncompliance identified.

**THE THIRD
PARTY LACKS
MATURE
CONTROLS.**

Small, private companies tend to lack the internal controls to prevent or detect noncompliance. These risks become particularly evident when small companies experience revenue growth that outpaces system and control development. An audit can reduce the risk of engaging small companies and help those third parties understand the value of investing in control development.

A formal contract compliance audit program strengthens your organization's enterprise risk management function—as well as supply chain and financial performance. Companies achieving strong supply chain performance have a 7 to 26 percent greater compound annual growth rate (CAGR) than the industry average, per a recent Accenture report.



Priority 3

Expanding into New Markets with Communication and Performance

In response to competitive pressures and market saturation, many organizations and C-suite executives are looking to expand into new markets. This focus is shared by many procurement leaders, with nearly 52 percent of survey respondents noting that it is a “strong priority” this year.

However, expansion efforts are often large and exceedingly complex, requiring extensive support from third parties.

For example, organizations can benefit from contract compliance audits when entering new international markets and integrating new technologies.

Ensuring Compliance when Expanding into International Markets

In some industries, companies are increasingly exploring growth opportunities and supply chain partners in emerging markets. Yet, their complexity and distance can hinder transparency and communication, thereby increasing costs and susceptibility to contract noncompliance.

Audits can help you reduce the risk and costs of international expansion projects by ensuring compliance with contract terms and operating procedures, as well as improving efficiency and governance throughout the third-party lifecycle.

Ensuring Compliance when Requiring New Technology

Many companies are also increasing technology investments to expand into new markets or launch new products. However, introducing spend in these less certain areas may add risk and potential for contract noncompliance.

For instance, with the aid of IT suppliers, some companies are updating infrastructure or using cloud-based solutions to combine their business processes and data into one network. Meanwhile, others are working with IT suppliers to develop new product offerings.

When partnering with various IT suppliers, a contract compliance audit can improve transparency and validate compliance. And, with the substantial investment required for most IT projects, contract compliance audits can serve as a key tool for ensuring maximum ROI.



Priority 4

Expanding by Acquisition with Consistency and Clarity

In addition to expanding via organic growth, many organizations are aiming to expand through acquisitions or mergers.

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Over 20 percent of CPOs surveyed indicated that expansion by acquisition is a *“strong priority.”*

However, with the high level of activity and complexity involved with integrating companies, it is possible that overbillings, noncompliance, and cost savings go undetected.

For instance, following are five of the most common third-party-related challenges procurement leaders may face because of an acquisition or merger, along with how a contract compliance audit may help to address each.

- **Differing Contract Terms and Policies.** Integration can become complicated when two organizations have differing contract terms, policies, practices, and operations. Audits can help to minimize the risk of inefficiency and overpayment.
- **Conflicting Contracts with Third Parties.** The CPO of the new organization often inherits conflicting contracts with third parties, making it difficult to manage transitions. Audits can validate that third parties have accurately applied the most favorable pricing terms and identify any transactions occurring outside the existing agreements.

- **Significant Personnel Changes.** With personnel changes following a merger or acquisition, audits are helpful to ensure that new employees fully understand contract nuances. Also, an audit minimizes the potential for risks by verifying that procedures continue to align with contract provisions.
- **Terminated Contracts.** Because of a merger or acquisition, third-party suppliers are often consolidated to avoid redundancy and reduce costs. When you're preparing to end a supplier contract, an audit allows for a more effective transfer of information and processes to the new supplier. And, if a supplier's services are extended beyond the contract expiration, an audit helps you to negotiate appropriate premiums.
- **Contract Renegotiation.** If you renegotiate a contract or put the business out to bid, an audit prior to sourcing events can yield long-term improvements in pricing, communication, accountability, and trust.

A well-executed analysis of third-party contracts—during and after a merger or acquisition—can establish greater transparency and contract alignment, strengthen relationships, identify savings opportunities and detect lost profits.



Priority 5

Increasing Capital Expenditures with Dependability and Transparency

In conjunction with growth strategies, many companies are increasing capital expenditures to upgrade or acquire buildings, land, or equipment.

In fact, overall capital expenditures are expected to increase for the seventh consecutive year, per a recent Institute for Supply Management report, and nearly 20 percent of CPOs surveyed indicated that increasing capital expenditures will be a “strong priority” this year.

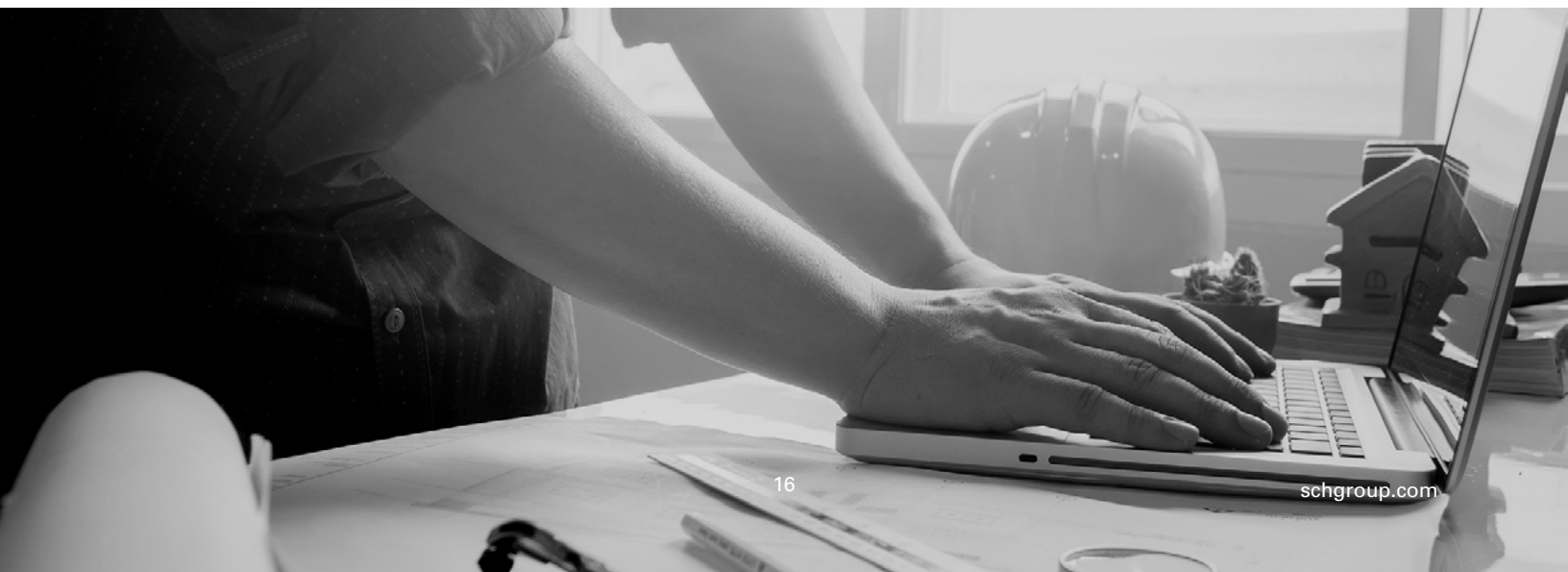
However, while capital expenditures are often essential to driving growth, they can also present a substantial risk for contract noncompliance.

For instance, large capital projects, such as upgrading or constructing a new facility or factory, require the management of numerous contractors and subcontractors. As a result, it can be difficult to:

- ✓ Ensure ongoing transparency, accountability, and communication
- ✓ Identify noncompliance and hidden contractor costs
- ✓ Not get distracted by minutia and day-to-day fluctuation

Contract compliance audits can help you and other C-suite executives to stay focused and demonstrate to stakeholders that you have a definitive plan to optimize ROI.

Audits ensure that contractors and subcontractors are operating within the terms defined in their contractual arrangements. Further, they validate costs incurred throughout the project’s execution are appropriate and authorized.





Common Questions and Confusions



While many procurement leaders are fully embracing the use of contract compliance audits, some are holding back due to misconceptions regarding audit requirements and results. Following are some of the most common questions we get from C-suite executives, along with the straightforward information you need to make a sound audit investment.

Will auditing a third party harm the relationship?

No. By ensuring that your requirements and goals are fully aligned with the third party's expectations, audits improve mutual understanding, minimize mistakes, and support the successful delivery of products and services. You gain assurance that the terms and costs are being followed, while the third party confirms its ongoing compliance with the contract terms.

Will an audit disrupt third-party operations?

When a contract compliance audit is performed by an experienced independent auditor, the daily operations of the third party are generally not interrupted. During audit planning, the auditors will develop and communicate a clear process and timeline to third-party personnel. Further, they will usually limit the involvement of key operational personnel, instead leveraging support from the third party's back-office finance department.

Is an excessive amount of time and support required from organizational stakeholders?

An experienced auditor will generally require less than five hours of stakeholder support per audit—a time investment more than offset by the potential for cost savings and process improvement. This typically includes a stakeholder conversation to review and sign off on audit specifications before work begins, updates provided during the audit process, and a discussion of results once the audit is complete. Additional support is required only on rare occasions.

Can audits be performed only if the contract contains an audit clause?

While a well-crafted audit clause guarantees access to third-party data and records, your ongoing relationship is usually sufficient to conduct an audit. Third parties nearly always cooperate with an audit request, as the audit is a way for them to build additional transparency and trust. Most third parties recognize that an audit offers opportunities for both parties to improve their processes.

Are most billing errors the result of intentional fraud?

No. Most invoice and payment errors are the result of a misunderstanding of intricate contract terms, an unintentional oversight in manual billing processes, or programming glitches. Nonetheless, they are common and costly. An experienced auditor can pinpoint errors and their possible causes, then recommend internal control enhancements that reduce them in the future.

Does resolving audit findings require legal action?

Since most billing errors are unintentional, legal or unilateral actions are exceptionally rare. The most common resolution to findings of inadvertent errors is a negotiated settlement, which is mutually agreed to by both parties. The customer-third party relationship is strengthened, with process improvements and contract clarifications that ensure future alignment and compliance.



WHAT ARE THE BEST TIMES TO CONDUCT A CONTRACT COMPLIANCE AUDIT?



When your organization or a third party undergoes an operational and structural change, such as a merger, acquisition, or significant personnel adjustment



Before a new service is posted for bid or an existing agency contract is terminated



When a third party presents a key risk factor, such as a material relationship, complex contract terms, operational challenges, or underdeveloped controls



During personnel changes



Periodically throughout long-term contracts



Engaging the Right Third-Party Auditor

While contract compliance audits can be performed by in-house personnel, many procurement leaders and other C-suite executives are recognizing the benefits of engaging an independent specialist.

For instance, many organizations do not have the staff availability, training, or technology resources to successfully conduct such audits in-house. Hiring a contract compliance audit expert will free up your internal resources and reduce the impact on organizational workload.

In addition, independent auditors bring a fresh perspective to the contract review process. By objectively assessing the internal systems and controls of both your organization and its third parties, an independent and experienced auditor can often identify unique opportunities for improvement.

Most important, though, are the benefits gained by engaging certified professionals who focus exclusively on contract compliance auditing, not general business consultants who include contract compliance as one of their many service capabilities.

The service specialization and expertise of dedicated contract compliance auditors allows them to most effectively identify ways to improve your business processes, provide outstanding transparency, and produce substantial ROI.

For More Information

To learn more about how contract compliance audits can help you meet key procurement objectives—through greater savings, transparency, accountability, and trust with third parties—click [here](#) for a no-obligation assessment from SC&H Group’s Contract Compliance Audit team.



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