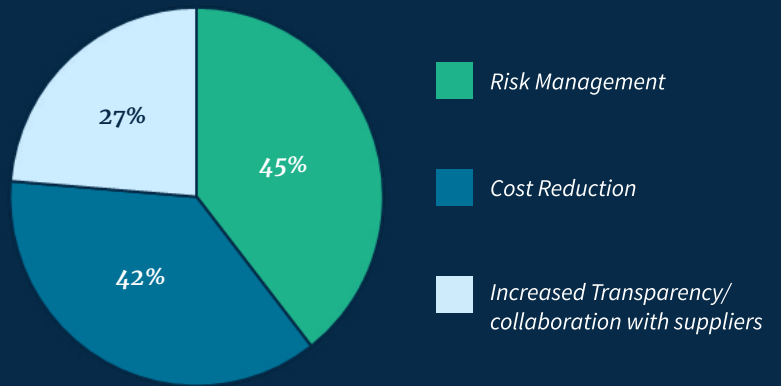


The Importance of a Mature Contract Compliance Audit Program



Modern procurement has matured into a complicated, multi-tiered arena. While the global marketplace and technology have introduced efficiencies, opened markets, and tapped new suppliers, these same advances come with risks that must be managed. In fact, in SC&H Group’s first annual Procurement and Sourcing Benchmark Report (released in September 2020), respondents noted risk management as a top priority, followed closely by reducing costs.

With an effective, mature contract compliance audit program in place, global enterprises can optimize business performance with strategic partners by replacing familiarity and blind trust with transparency, accountability, and earned trust. One can add to the complexities of doing business in the 21st century a global pandemic, the impacts of which will be felt for some time to come, and economic volatility. In today’s environment, the presence of an effective contract compliance audit program is more critical than ever before.



The Mature Contract Compliance Audit Program Defined

Consistent

Many companies conduct contract compliance audits and rightfully so – it’s a best practice and an attribute of a forward thinking, world-class organization. What differentiates a mature contract compliance audit program – and makes it more valuable – is that it occurs regularly, on a rotational basis, consistently validating that all key suppliers are complying with the terms of their executed contracts.

Organizations with the greatest opportunity for improvement are generally only doing limited audits on an ad-hoc basis when an issue has already arisen. In other words, those audits take place when it is too late, when inefficiencies and concerns are already pervasive, savings are lost, and exposures from a multitude of risks exist. On the other end of the maturity spectrum, world-class organizations are looking at supplier populations holistically and developing risk-based assessments that lead to a strategically planned, multi-year rotational audit program. Periodic and rotational contract compliance audits support ongoing monitoring efforts, which is an essential element of the supplier management lifecycle and enterprise risk management.


Socialized

In a large enterprise, it is inevitable that siloes develop, yet procurement is an area where many different players have valuable input to help bridge the gaps and optimize stakeholder alignment and the organization’s performance. A mature contract compliance audit program is one that is socialized with all key stakeholders, including business owners, finance, [data security and privacy officers](#), internal auditors, legal, and the C-suite to ensure the enterprise is in alignment and supports the ongoing monitoring of supplier relationships. Stakeholder buy-in is an essential component to optimize audit performance and results. In order for this process to be conducted effectively, there should be one entity that takes ownership of the audit program. The SC&H Procurement and Sourcing Benchmark Report indicates that while many companies believe they have a mature contract compliance audit program, ownership of the process is inconsistent. Programs without clear ownership and accountability may not follow through on audit discoveries and remediations.

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Universal

In a mature contract compliance audit program, all suppliers – both direct and indirect – are subject to the same process and held to the same best practices. The Procurement and Sourcing Benchmark Report found that 64 percent of organizations “only audit Tier 1 suppliers or ones with the highest degree of spend.” This approach ignores Tier 2 and Tier 3 suppliers, which may not have the same degree of spend but are often identified as hard to replace, sole-source suppliers. Degree of spend is also not the only benchmark by which an organization can judge its vulnerability to contract incompliance. By consistently executing audits with all tiers of suppliers, the program ensures that the company’s contracts are operating as intended and negotiated savings are being received. If necessary, an audit program can identify aspects of the relationship that need improvement. All too often, areas of financial leakage and opportunities for improvement go undetected absent an in-depth examination of the transactions between the parties against the terms of the executed agreements. In this way, the mature audit program is a win-win: The enterprise gains peak performance and protects the bottom line while the supplier maintains the integrity of its relationship with an important business partner by providing transparency and accountability.



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Benefits of a Mature Contract Audit Program

Procurement and sourcing professionals understand that a contract must be managed over its entire lifecycle. Consistent oversight and ongoing monitoring helps ensure the contract and the supplier relationship are operating as intended which, in turn, mitigates risks such as cost overruns, compliance violations, even fraud.

Contain Costs & Protect Earnings

Absent a mature contract compliance audit program, a business is vulnerable to any number of costly errors, including paying more than contracted for a good or service, erosion of negotiated savings through undisclosed charges, rogue or off-contract spending, and financial penalties as a result of data privacy regulations, all of which can have an adverse effect on earnings. Businesses who partner with SC&H to implement an enterprise-wide contract audit program typically see a return on investment (ROI) of more than 200 percent, a clear indicator that a mature program more than pays for itself.

Strengthening Contracts

In addition to containing costs and protecting earnings, a mature contract compliance audit program gives insight into the inner mechanics of the contract itself. By periodically comparing what is transpiring in the customer/supplier relationship against the terms of the contracts, it is easier to identify terms that need to be clarified to avoid misinterpretations and reduce the likelihood of unintended consequences. This oversight can prevent financial leakage and translate into additional savings over the contract's lifecycle. Also, creating a strong baseline for contract compliance is a good foundation that supports long term ROI through a sentinel effect throughout the supplier population.

Risk Management

While cost savings are an important benefit to maintaining a mature contract compliance audit program, there are vital risk management advantages as well. Recurring, rotational audits are essential to identifying regulatory or compliance violations and other risk exposures.



The risk management landscape expanded with the passages of Europe's General Data Protection Regulation (GDPR) in 2018 and the California Consumer Privacy Act (CCPA) in 2020. These laws make safeguarding the personal data of customers not only a best practice, but also a mandate for global enterprises. Yet enforcing effective compliance across a vast supply chain can be daunting, particularly when that supply chain is comprised of a diverse set of companies of varying size, sophistication and geographical location. An advanced contract compliance program validates supplier policies, procedures and controls to ensure they comply with data privacy regulations and are adequate to mitigate the risks of data security and data privacy violations.

The protections provided by a mature audit program are important because lack of knowledge of these violations will not mitigate the consequences that may arise when they come to light. Contract non-compliance can be costly both financially and to a company's reputation. Mitigating supplier risk is an important benefit delivered by a mature contract audit program and an essential element of comprehensive risk management strategy.

Relationship Building

There is a misconception that a contract compliance audit program can be adversarial, pitting one's enterprise against its' suppliers and subjecting them to undue scrutiny. When conducted by professionals who understand the benefits and processes entailed in an effective audit, this is never the case. On the contrary, bringing the enterprise into alignment with its suppliers on costs and compliance creates a stronger relationship. An audit reports on both favorable and unfavorable observations to create a full picture of the effectiveness of the contract, processes, and controls and where each can be improved to act in better harmony. When all parties embrace a culture of best practices and continuous improvement, the business relationship advances to one of trust and respect with the utmost transparency and accountability.








A Proactive, Universal Approach

Too often contract audits are reactionary: there has been a compliance violation or a costly mistake that throws into relief inadequate oversight of the contract. Companies must manage myriad competing priorities and often they lack the time or resources to adequately address supplier oversight. Even those companies that believe they have a contract compliance audit program in place may overestimate the nature and scope of those programs. Programs managed by internal audit groups can be susceptible to bandwidth constraints and lack of subject matter expertise for complex, high-risk categories like construction or marketing and advertising. After all, internal auditors are tasked with executing numerous audits across the entire enterprise and supplier auditing is a small (and potentially neglected) portion of a broad audit plan.

SC&H is an experienced audit partner that is focused on helping our clients develop a mature and sustainable contract compliance audit program. We leverage experience and risk awareness to generate the highest possible economic value while delivering transparency that helps clients enhance supplier relationships. Audits are performed in an objective, professional and efficient manner, creating consistency for both the enterprise partner and its suppliers. The fact-based reporting is transparent for all parties and helps companies make fair, informed decisions about how to remediate non-compliance. By making audits a routine aspect of conducting business, the risk of unpleasant surprises and costly mistakes is significantly reduced. When it comes to managing the vast sphere of an enterprise's supply chain, it is important to be proactive and apply best practices across all suppliers in a uniform way.


Mechanics of a Mature Audit Program

-  **There needs to be a strong cadence and alignment between Procurement and stakeholders across the enterprise – including business owners, Finance, Internal Audit, Legal, and the C-Suite - supporting ongoing and periodic supplier audits. A contract repository exists where contracts are organized and can be pulled.**
-  **There needs to be clear ownership of the audit program.**
-  **It must be consistently executed against all tiers of suppliers – a “we only audit when issues arise” approach will not bear the fruits you can expect from a mature program.**
-  **It should not be reactionary or temporary.**
-  **All suppliers, both direct and indirect, are subject to this best practice.**

Risk Management in a Risky World

In the 2019 Deloitte Global CPO survey of nearly 500 CPOs, 61 percent felt procurement-related risks have increased over the last 12 months. Of those risks, economic downturn was a key concern for many procurement professionals. This is understandable; in recent decades, the United States witnessed a major recession, and significant volatility across global markets. In 2020, the business world is grappling with the coronavirus pandemic, which has caused unprecedented changes in personnel operations and major market and supply chain disruptions. The political, economic, social, and cultural impacts of the pandemic will no doubt be longstanding and evolving.

The lesson to be taken from these challenges is that businesses operate in a risky world. Operations can literally change overnight. While it may be tempting to deprioritize contract compliance auditing, particularly when operating in a major crisis, it is in times of turmoil that the mature audit program will realize its full potential. The need for cost savings, open and positive relationships with suppliers, and strong understanding of the functioning of contracts is even more important when volatility becomes the new normal.



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Frequently Asked Questions

We have internal auditors to take care of this – what makes a mature program different?

While some companies perform contract compliance audits on a limited or ad-hoc basis, an advanced program is one that is conducted on an ongoing basis, across all tiers of direct and indirect suppliers, not haphazardly or when there is a problem. They are strategically planned, often ensuring a rotational coverage of all high-risk suppliers. Often, internal audit does not have the resources or subject matter expertise to execute a mature contract compliance audit program considering all the other tasks included in their audit plan which spans the enterprise. Partnering with a specialist such as SC&H, whose certified professionals are focused on executing contract compliance audit programs for Fortune 1 - 500 companies, can help your organization develop a mature and sustainable process that delivers significant, recurring benefits.

Is it really worthwhile to engage in a mature audit program?

SC&H's clients typically realize an average ROI of more than 200 percent. Quantifying the value of transparency generated or the foundation of trust enabled by an audit is less quantifiable, but no less valuable.

Won't this form of audit program make my supplier feel attacked and damage our relationship?

SC&H utilizes a collaborative, fact-based audit approach that looks at the entire process (not just supplier spend, for example) and reports both favorable and unfavorable findings. The goal is to develop a holistic understanding of the parties' compliance with their respective contracts that benefits all involved. When non-compliance is identified, the supplier's input should be solicited, whether or not they agree with the issue or remediation required. In this way, each company can make an informed decision about how to resolve complicated issues. This also ensures that while a supplier may not be happy about an audit outcome, they can feel the process was fair and reasonable.

What if we don't have an audit clause in our contracts?

Contract compliance audits are generally accepted best practice supported by suppliers in the spirit of the relationship and transparency. As long as there is an active relationship, conducting an audit is very rarely an issue. Just ask.

Do audits require Legal involvement? What if the audit results in litigation?

While the legal department should be made aware of the audit program, most companies with a mature audit program only involve legal in the audit process when necessary, which is usually on rare instances. When needed, legal can provide an opinion on contract terms and the validity of disputed differences identified during the audit. Typically, any disputes between the company and the supplier over issues identified during the audit are generally resolved without legal involvement via good faith negotiations between the parties. Arbitration or litigation because of the audit is extremely rare because there is rarely a cost-benefit to either party.

We worked with a third-party auditor and had a poor experience; why would this experience be any different?

Your products and services are only as good the raw materials you put into your work. Similarly, the experience of working with a third-party auditor is only as good as the auditor. SC&H has extensive experience working with Fortune 1 - 500 companies with significant spend under contract with global suppliers. We have achieved marked results for our clients. Our approach to a mature contract audit program is differentiated by our focus on collaboration. We utilize a proven approach which focuses on collaboration, developing a customized business case, and helping stakeholders socialize the program across the enterprise to obtain company-wide support for the initiative. When a contract compliance audit program matures and is fully optimized, everyone from the C-suite to the third-tier supplier will benefit.

Conclusion

In addition to generating savings and mitigating third party risks, CPOs have a heightened desire to improve collaboration with internal stakeholders. At the same time, they want procurement to have better, more transparent relationships with suppliers. A mature contract compliance audit program benefits these myriad needs: it confirms negotiated savings are received, prevents financial leakage, identifies additional savings opportunities, manages internal and external risks, strengthens transparency and relationships, promotes accountability, and provides the enterprise with the insights it needs to optimize performance and protect earnings.



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