

A blurred background image of a business meeting. Several people are seated around a table, looking at documents and charts. The focus is on the hands and papers in the foreground, with the rest of the scene out of focus. The overall tone is professional and collaborative.

E-book:

# Building A Self-Funding Contract Audit Program

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**PRGX<sup>®</sup>**

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# Building A Self-Funding Contract Audit Program

A tremendous amount of time and effort are put into negotiating supplier contracts. And, it's just common sense to check-in periodically and make sure everything is working as intended.

That's what a contract compliance audit does. By rigorously reviewing vendor contracts, businesses can find sources of value leakage, recover lost profit, and better yet, stop the errors causing the leakage from occurring again.

Most procurement departments, however, lack the budget, expertise, and bandwidth to audit vendor contracts effectively, leaving the door open to sustained loss.

Those issues can be overcome by engaging an expert audit partner and even designing a self-funding audit program that captures historical recoveries, uncovers systemic issues, and stops future leakage from slipping through for the duration of the contract.

In this e-book, we'll describe the cornerstones of a robust contract compliance audit methodology and explain how it can be designed to pay for itself — even while an audit is underway.

# Contract Compliance Audit Explained

There are two main types of contract compliance audits:

- 1 Traditional program
- 2 Robust program

Contract compliance audits apply a methodology for reviewing supplier relationships to verify it is in line with what's been negotiated in contracts, change orders, and other contractually-binding agreements.

Many companies have hundreds, thousands, and even tens of thousands supplier relationships that they spend millions or billions on every year. With so many invoices, projects, and contracts associated with these transactions, it's easy for things to slip through the cracks. That's why contract compliance audits are considered a best practice.

There are two main types of contract compliance audits:

**The first is a traditional program** which focuses on high-risk vendors. Perhaps they're in a category with high spend, have complex

contracts, or there have been issues in the past. In these cases, the audit is focused on drilling down into each specific vendor's billing practices.

Traditional contract audits are effective if in-house bandwidth is limited, the main objective is the recovery of lost profit, and the focus is on a small pool of vendors. This type of audit can identify cash savings fairly quickly but is more limited in addressing avoidance of future leakage.

**The second type is a robust program**, which delivers everything the traditional audit does — plus a lot more. It's focused on delivering sustainable value, both to the bottom line and through enhanced supplier relationships.

# Maximizing Value With A Preventive Approach

A robust contract compliance audit can include any of the following:

- **Pre-event audits** that review invoices before they're paid and projects before they're awarded.
- **Diagnostic audits** that review contract language along with current process and operational controls.
- **Accelerated audits** that cover continuous monitoring to ensure Total Cost of Ownership (TCO) and Service Level Agreement (SLA) verification.
- **Real-time audits** that cover capital projects.
- **Specific risk audits**, which cover lower-tier vendors, non-financial risks, or targeted high-risk errors.

The benefits of a robust audit aren't limited to historical cost recovery. Their real value lies in prevention and the future value that can be achieved by rooting out the causes of leakage.

Traditional contract compliance audits are an excellent methodology for identifying points of leakage and recouping a percentage of historical loss.

They complement a more robust audit by providing insight into problems that may exist across supplier relationships.

**In contract compliance, there are three primary sources of value:**

- 1.** Historical cash recoveries where loss is recouped.
- 2.** Supplier-specific gap mitigation where one supplier is reviewed for specific concerns within the contract, its financial operations or other issues in the relationship.
- 3.** Systemic gap mitigation where the auditor identifies issues prevalent across multiple suppliers within a spend category.

When systemic gaps are closed, the value returned by corrective action can be significant – a real step change for the organization.

# What Stops Companies From Realizing The Full Benefit Of Contract Compliance Audits?

The potential value of a full, robust contract compliance audit methodology is much higher than historical recoveries alone can deliver. So what keeps companies from going beyond the remit of traditional audits?

**Budgets:** There may not be sufficient funding available to support a traditional contract compliance audit. But if funding can be aligned to program objectives, the audit program can create a positive return on investment.

**Limited management resources:** Audit programs require engagement with suppliers and internal stakeholders, which involves time and flexibility from procurement teams.

**Concern about upsetting key supplier relationships:** The audit process involves, at a minimum, asking for money back. In a robust program, it also requires scrutiny over supplier conduct and internal processes and behaviors. That raises potential issues that have to be managed with sensitivity and care.

## There are four ways to overcome these obstacles:

1. Ensure top-down alignment so all stakeholders agree with audit objectives.
2. Establish a funding model suited for the audit's objectives.
3. Build a project plan that addresses both operational controls and governance to ensure there's appropriate bandwidth to properly manage the project.
4. Communicate the benefits of the program to key stakeholders and suppliers, so they understand the reason for examining their practices.

# Top-Down Program Alignment

In all cases, it's **vital** to build a **reporting and escalation process** into the program so all are fully informed.



Clearly defining the objectives of the program and then communicating them at every level will help expand support for the program beyond procurement.

- If the objective is limited to historical cash recoveries, then that needs to be made clear so that all involved are working towards that goal.
- If gap mitigation is the emphasis, then the program objectives will involve more nuance. That raises the bar for communications and typically demands more regular updates to stakeholders and senior management.

Businesses taking a balanced approach between the two can use cash recoveries to fund the more robust audit methodologies that plug the leaks and stop future overcharges and erosion of profit.

In all cases, it's vital to build a reporting and escalation process into the program so all are fully informed before settlement actions are taken. Stakeholders should be educated about the fact that auditors are fully expected to find errors, and their focus is on developing a plan for realizing future savings.

Having alignment with senior leadership throughout the organization is the most effective management model to realize the full potential of a contract compliance audit.

# Self-Funded Audits

Recoveries can be accumulated in a **central audit reserve** that is used in turn to fund the ongoing program.



A self-funding model for audit programs typically uses a hybrid structure, blending contingency and hourly fee structures that align to the project's objectives. A budget is typically established that's reimbursed through historical recoveries.

When a budget is not feasible, there are funding approaches which can accomplish the same result. For example, recoveries can be accumulated in a central audit reserve that is used in turn to fund the ongoing program. It can be a joint investment between the company and audit firm. This ensures both parties have "skin in the game."

Audits have direct and indirect costs related to internal management of the project and may have sponsorship costs as well.

These can be underwritten with a self-funding model that replenishes audit reserves continually from recoveries. Any amount of recoveries leftover can be allocated elsewhere.

Another option is to treat current fiscal year recoveries differently from prior fiscal year recoveries. Since the books are closed on prior years, it may be inappropriate to credit prior year recoveries to current year budgets. In these cases, audit proceeds from prior year transactions could be reserved to fund the ongoing program.

## Establishing A Management Structure And Appropriate Bandwidth

A robust audit program focused on rooting out systemic issues should have a governance structure that reassures stakeholders and a plan that sets milestones so everyone involved has visibility of progress toward objectives.

From day one, the audit team should be in close contact with the program lead and report any roadblocks early. A higher-level update should be provided to executive leadership every quarter. In all cases, updates offer the opportunity to share successes and lessons learned, and factor them into future planning.

An auditor might identify a systemic issue like ambiguous contract language that could have an impact across systems or contract types. Communicating that more broadly can assist in the implementation of corrective actions as the program grows and validates associated capabilities.

In some cases, companies don't have the internal bandwidth to manage the program effectively. When that happens, it makes sense to have an embedded professional program manager from the audit partner handle day-to-day project management. This eases the burden on staff and can help accelerate the program to achieve full value.

## Strengthening Key Supplier Relationships

Sensitivity to the concerns of key suppliers has to be top of the agenda when any audit is underway. However, strategic suppliers typically have a partner relationship with their biggest customers and should be ready to welcome activity that aims to smooth the relationship even further.

A contract compliance audit aims to ensure that what was negotiated by both parties is reflected in invoices and that financial terms and conditions are operating as expected.

It's about embedding best practices and not exposing wrongdoing. Position it as a health check that can identify gaps in the understanding of contract language, or areas where both parties can benefit from process changes.

At the end of the process, the supplier relationship should be strengthened. Everyone can breathe a sigh of relief that there are no more unknowns to deal with. The increased sense of transparency becomes the basis for a more stable relationship built on mutual trust.

# Finding Maximum Value With A Blend Of Old And New

## About PRGX

Traditional contract compliance audits haven't lost their essential value. In fact, the process of identifying historical recoveries enables auditors to conduct the risk assessments needed to determine where systemic issues may be hiding. Gathering that intelligence is vital to optimizing supplier relationships and stopping money from unnecessarily going out the door.

PRGX helps companies spot value in their source-to-pay processes that other sophisticated solutions didn't get to before. Having identified more than 300 common points of leakage, we help companies reach wider, dig deeper, and act faster to get more value out of their source-to-pay data.

We pioneered this industry 50 years ago, and today we help clients in more than 30 countries take back \$1.2 billion in annual cash flow.

The robust audit methodologies and self-funding project models developed by PRGX combine decades of human experience with advances in technology. Both are enabling our auditors to uncover the systemic, contract and process issues that cause value leakage.

It's why 75% of top global retailers and a third of the largest companies in the Fortune 500 rely on us.

**For additional information on PRGX, please visit: [www.prgx.com](http://www.prgx.com)**