E-book:

# Commercial Compliance Audits: From Reactive To **Proactive**

PRGX®

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# Shifting Contract Compliance Audits: Moving From Reactive To Proactive

Historical cash recovery has been a core benefit of contract compliance audits for as long as they've existed. But the most astute companies are now demanding more.

As good as traditional audits are at identifying recoveries, the value they can realize is only ever a percentage of what's been lost. And the longer the timescale between transaction and recovery claim, the more challenging recoveries become.

With contract compliance audits typically covering up to four years in retrospective analysis, suppliers have become adept at challenging recovery claims. Many wonder why technology isn't helping to flag issues sooner, so they can be sorted without resorting to forensic reconstructions of past events.

Those reconstructions require time from procurement personnel, who must be available for questions to clarify contracting intent. Completing an audit can take up to six months, with regular input from the procurement team needed throughout the process.

Customers are rightly starting to question whether there's a better way. And there is.

By moving to proactive methodologies, businesses can stop cash from going out of the door - vastly increasing savings made versus the proportional amounts that retrospective approaches deliver.

In this e-book, we'll look at the new capabilities that are shaping today's commercial compliance audits, and explain how businesses can shift from catching the drips to stopping the leaks with a more informed, data-led audit process.

# Identifying Systemic Errors And Root Causes

Contract compliance audits are an effective way to identify past leakage and recoup losses through claims. The number of errors uncovered can be significant, but the volume of recoveries generated by traditional audits can obscure how many errors are recurrent.

Decades of experience combined with advances in technology are now transforming the traditional audit into an opportunity to uncover underlying issues in billing compliance that let repeated overpayments slip through.

When those are identified, sustainable long-term controls can be implemented that stop losses before they happen.

By diagnosing the root cause of a problem, you can cure it instead of endlessly treating its symptoms. Value is maximized when the root causes of gaps are mitigated, and leakage is prevented rather than recouped.

There are five essential methodologies for rooting out and proactively identifying and mitigating the root causes of billing and overpayment errors.

# Identifying Systemic Errors And Root Causes

## 1. Pre-event Audits

Employing audit procedures before billing and payment to prevent errors before they are made.

**Trigger 1: Pre-award:**
Analyzing risks before a supplier contract is awarded and then incorporating what you learn into commercial terms.

**Trigger 2: Pre-project:**
Considering all the cost components associated with labor rates and prices, and ensuring non-allowable costs are excluded.

**Trigger 3: Pre-payment:**
Enforcement of actual contract terms and billing procedures by verifying prices and ensuring proper documentation of costs just prior to invoice approval.

## 2. Diagnostic Analysis

Looking for problems in client systems around contract language by commodity, invoicing processes, and operational controls so processes and controls can be strengthened and billing errors rooted out and mitigated faster.

# Identifying Systemic Errors And Root Causes

## 3. Accelerated Audits

These are similar to traditional contract compliance audits but engineered to execute quickly and stop significant leakage sooner.

## 4. Real-time Audits

This is where auditors go out into the field to conduct 'live' audits while specific activities are underway, very useful in chaotic operating environments like plant turnarounds or major capital projects.

## 5. Specific-risk Analysis

Targeting known problems related to the industry or business type within contracts and designing procedures to mitigate them.

# The Importance of Pre-Audit Analysis

While all five methodologies are essential, pre-event analysis creates vital opportunities to stop leakage before it happens.

## Pre-award:

This involves clarification of actual terms to eliminate grey areas. The risk lies in different interpretations of contract language. If ambiguities can be identified early, it's easier to avoid future disagreements. Supplier contract language will always be worded to protect them first. When ambiguities and potential for future leakage are identified, they can be proactively mitigated before billing against those terms even begins.

One example of this can be labor rates. Sometimes contracts fail to provide a proper build-up schedule or audit rights for the buyer. Contract language should enable buying companies to audit labor rates and avoid potential overcharging.

## Pre-project:

The contract language should provide visibility into the accuracy and transparency of all cost based elements, including labor billing rates. Auditing the base wage and the cost-benefit components attached to each proposed rate will identify the real cost of wages and benefits, and enable the buyer to exclude non-allowable costs.

One example of this might be mileage costs added on later in the billing cycle that were already included in the base wage.



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# The Importance of Pre-event Analysis

## Pre-payment:

This involves enforcement of the actual contract terms and the billing procedures attached to a contract. Several best practices come into play to ensure accuracy in prices and labor rates charged, mark-up percentages being applied, inclusion of allowable versus non-allowable costs, and whether or not the supplier is providing proper documentation for allowable costs.

Change order documentation can provide ample opportunities to identify hidden contract risks. Change orders are based on estimates, and there needs to be reconciliation between the estimate and what was actually paid. If the cost applied in a change order turns out to be less than the estimate, a credit will be owed. Adding controls relating to approval documentation can eliminate the risk.

# Success Story

## The Challenge

The developer of a multi-year construction contract encompassing 920 acres of land and 8.3 million cubic yards of earth that needed moving, to construct new facilities covering 3 million square feet — for $1.5 billion. Two construction firms were hired under a joint-venture contract to deliver the project.

Monthly invoicing included costs for the two general contractors, plus costs from 35 sub contractors. On average, there were 600 orders made from the site each day. The monthly pay allocation included hundreds of pages of documentation which all had to be compared to contract terms. Each invoice included multiple change orders — over 300 on one particularly complex invoice — each with backup ranging from one page to several hundred pages. Tracking these changes and associated cost builds was very challenging. PRGX had to ensure that non-allowable costs were excluded and that all work had been completed.

The project owner's priorities were to keep the project on schedule and keep cash flowing to the contractors and sub-contractors. Audit activity could not be allowed to become a bottleneck.

# Success Story

## The Solution

Throughout the project, PRGX conducted real-time contract compliance auditing to provide the preventive detection of invoicing anomalies that could lead to leakage, correct them, and deter overcharges.

Given the scope of the project and the scale of the budget, conducting a traditional, recoveries focused audit at the end of the project would have been difficult and time-consuming, with layers of complexity that needed to be unpicked.

PRGX set up a proactive contract compliance audit process that could identify risks and process issues, and mitigate them early on.

In this engagement, the pre-award analysis conducted before the contract was finalized was essential. Several issues related to auditing rights and cost definitions were identified that, once settled, allowed the contract owner proper oversight of underlying rates and costs.

This enabled PRGX to do an up-front audit of labor rates against actual costs relating to base wage and benefits for each of the billing rates. There were significant non-allowable costs attached to many of the rates being charged.

After a period of negotiations, PRGX was able to closely match the actual rates and reflect them in the final contract.

## The Results

- On labor rates alone $7 million in preventive savings were secured for the contract owner.
- $4 million in savings due to payment error prevention were secured.

# Move From Retrospective To Future-focused

Erroneous billing errors can recur over time, extracting recurring costs from the business. But if the underlying cause of a recurring problem is fixed, the savings recur as well. Once a problem is fixed, the company continues to receive the benefit of the corrective action.

As procurement teams review their ongoing contact compliance programs to ensure they derive maximum value, there are five steps they can take to move from a reactive to proactive footing:

## 1. Partner With An Experienced Market Leader

The proactive approach to contract compliance audits is a cutting-edge way of thinking that goes beyond historical programs that were built strictly on a retrospective mindset. You need a partner with the experience and track record to guide you through the process.

## 2. Define Objectives

Work with your audit partner to define the objectives of the program. Too often, we find a lack of clarity and alignment between program objectives and the strategic objectives of the broader business.

## 3. Establish Your Program Management Model

A proactive contract compliance audit is a multi-faceted program that touches numerous internal and external stakeholders. It’s essential to build in strong governance and performance management to ensure you achieve full value.

# Move From Retrospective To Future-focused

## 4. Develop A Program Plan

Define exactly how the plan will roll out, and over what timescale. Answer key questions such as:

- Which vendors or categories will be subject to audit methodologies?
- What are the opportunity areas?
- How will risks be defined?

The results of these questions can be used to build a specific step-by-step plan to address them.

## 5. Launch Proactive Methodologies

Get the program underway and blend your proactive methodologies with traditional retrospective audits and know where the two can complement one another. Couple those two components effectively, and you'll put the business in a position to generate maximum, ongoing value.

# The Power Of Prevention

Traditional contact 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 are hiding. Gathering that intelligence is vital to optimizing contracts and stopping money from going out of the door.

The added scrutiny suppliers find themselves under can also lead to self-correcting behavior. If they know a proactive contract compliance audit process is in place, they'll be more likely to treat invoices with the rigor they deserve. Any lazy assumptions built into a supplier's invoicing processes ('well, they paid it so it must be approved') will also wither away if they know that anomalies will be challenged.

The new proactive audit approach developed by PRGX combines decades of human experience with advances in technology. Both are enabling our contract compliance auditors to use what they learn and uncover contract and process issues that cause value leakage.

# About PRGX

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. 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.**

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