



CONTRACT COMPLIANCE AND COST RECOVERY

Understanding the Symptoms to Discover the Root Causes

RISK ADVISORY • TAX • FINANCE & ACCOUNTING

Tired of negotiating contract savings, but not realizing them?

You are not alone. In today's global marketplace, organizations are challenged to reduce costs by negotiating harder, buying smarter and leveraging every possible advantage to increase the bottom line.

By conducting an in-depth contract compliance audit, an organization can evaluate its exposure to overpayments, identify control weaknesses in its purchasing processes, recommend strategic process improvements to mitigate contract risks and improve the accuracy of vendor transactions.

How do you know if your procurement process is "sick" and needs some assistance to nurse it back to health? The following are symptoms that could indicate contract errors are lurking:

- Missed negotiated price downs due to complexity of contract
- Currency changes and conversions
- Cost amortized, system(s) does not track
- Volume discounts, system(s) does not track
- Buyer turnover and inexperience
- Engineering costs not applied correctly, systems interface
- Clerical errors: transposed numbers or decimals, contract changes that affect the price
- Changes in units of measure
- Multiple legacy systems, not fully interfaced

- Insufficient documentation from sourcing to current contract terms
- Replacement contracts without carryover provisions

A PROCUREMENT OFFICE CONVERSATION: SEARCHING FOR ANSWERS

Chief Procurement Officer: "We are not close to our 20 percent annual spend savings target. What's the problem? Any suggestions?"

Purchasing Director: "It's getting harder for our vendors to reduce prices when their costs continue to rise. Our relationship with our supply base is beginning to erode."

Finance Director: "I recently reviewed several purchasing contracts and uncovered several instances where we did not pay our vendors to the negotiated contract terms and conditions for a variety of reasons. In most cases, we overpaid!"

Chief Procurement Officer: "So, we may not have been realizing our prior efforts to reduce costs and are sitting on potential recoveries that may help with our annual savings budget. That's the good news. But how did this happen?"

Finance Director: "I'm not sure, but we're working on understanding the symptoms so we can identify the root causes of these contract errors."

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CONTRACT COMPLIANCE AUDIT APPROACH

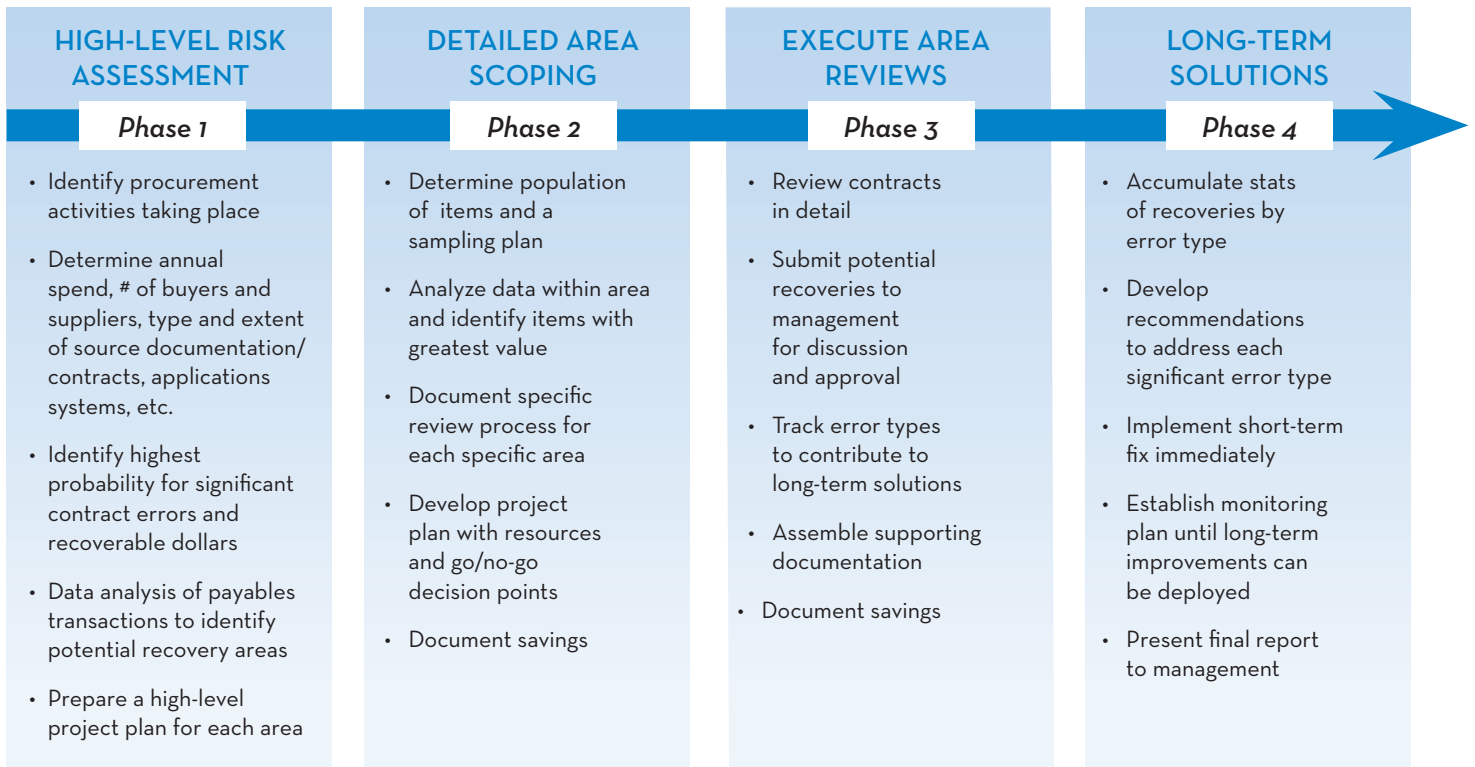


Figure 1

WHEN TO PERFORM A CONTRACT COMPLIANCE AUDIT

Other than routine scheduled audits, contract compliance audits are most critical when an organization has complex contracts that include embedded leases, long-term guarantees, price downs, retroactive pricing, rebates, special vendor agreements and business plans for ongoing productivity reductions. Other triggering events include a recent system(s) upgrade or conversion, applications that may not handle data consistently, or when there has been a merger or acquisition.

Historically, these types of audits have been performed for compliance (tactical) reasons and focused on validation of controls, exposure to risk, and policy and process improvements. Organizations are now realizing that a valuable by-product of the contract compliance process is the cost recovery/savings aspect.

Consider the case of a large global manufacturer that negotiates numerous complex contracts. In some contracts, it amortizes capital costs incurred by the vendor and paid by a proportionate increase in the cost of goods purchased based on a determined number of shipments. However, the manufacturer's purchasing systems cannot

accurately track this arrangement, making it a manual process that needs review by the individual buyer. Problems occur when this amortization agreement takes three to four years to repay, the firm has had three buyers assigned to this supplier during this period, and little, if any, original documentation exists.

As the result of a contract compliance audit, the manufacturer discovered that the payment of the capitalized cost would be achieved after the 10,000th shipment, with the embedded cost of \$10 to be removed at that time since the vendor would have been paid in full. What did the audit find? There were over 60,000 shipments, no changes to the contract and an overpayment issue of approximately \$500,000.

A FOUR-PHASE, FOCUSED APPROACH

Using a simple four-phase approach (see Figure 1) organizations should focus their efforts on areas that can make the largest financial impact while addressing purchasing process activities and specific system issues. The contract compliance review process starts with the procurement

contract and ends with disbursements. A contract life-cycle audit is employed from initiating purchase order to current contract status, using data queries, risk models and statistical sampling to minimize manual effort and direct attention to compliance areas and recovery issues.

- **Phase 1** is a high-level assessment that identifies likely areas for compliance and cost recovery opportunities
- **Phase 2** determines which areas are candidates for a full-scale review
- **Phase 3** is a full-scale audit that identifies recovery/saving opportunities and identifies root causes of errors in specific areas
- **Phase 4** provides ways to detect, prevent and repair the root causes of errors

MOVING FROM ROOT CAUSES TO IMPROVEMENTS

An in-depth audit of an organization’s purchasing contracts using an audit approach similar to the one described above will reveal symptoms pointing to contract errors.

In another actual case, work papers of a contract compliance audit revealed symptoms pointing to contract errors. The blue items in Figure 2 below illustrate errors that should be addressed or costs that should be recovered from vendors.

After reviewing source documentation and purchasing system contract notes and discussions with the buyers involved, it was determined that the organization missed the second year of the 5 percent reduction on 03/1/08, erred in reconverting from Canadian to U.S. currency,

received over 5,000 shipments and failed to reduce the full impact of the original packaging increase.

Document observations

Once symptoms are identified and addressed, it is necessary to document useful and relevant observations. These observations could include: recordkeeping standards, buyer on-boarding training, reassessment of policy/procedures and enhancements to purchasing systems.

After observations have been identified and agreed upon, it is important to consolidate and categorize them to strategically and efficiently address the root causes of contract errors.

Typically, the root causes for procurement contract errors fall into four categories: 1) lack of adequate training, 2) purchasing system applications and interface, 3) inadequate document management strategy, and 4) ineffective purchasing processes and procedures. These categories will be more or less affected depending on each organization’s situation and circumstances.

The audit provides cost savings/recovery opportunities, identifies symptoms that cause contract errors and categorizes these symptoms into high-level root causes for process improvement recommendations.

Frequently, a “quick fix” is recommended to address symptoms before getting at the root cause of the problem, which may take longer to remedy. Later, a strategic plan for long-term solutions should be initiated to reduce the exposure to contract errors and mitigate the risks associated with the identified root causes.

INFORMATION FROM WORK PAPERS OF A CONTRACT COMPLIANCE AUDIT

Purchase Order	Date	Price	Currency	Reasons
12345678	01/1/07	10.00	US	New component part
Amendment 1	02/1/07	12.00	US	Increase in packaging costs
Amendment 2	03/1/07	11.40	US	5% price down, first of three years
Amendment 3	08/1/07	12.20	CAD	Vendor plant move to Canada
Amendment 4	02/1/08	14.20	US	Engineering change to part
Amendment 5	06/1/08	19.20	US	Amortized costs for 5,000 units
Amendment 6	07/1/08	19.20	US	Payment terms changed
Amendment 7	08/1/08	18.20	US	Reduced packaging costs

Figure 2

REASONS FOR A CONTRACT COMPLIANCE AUDIT

Tactical Reasons	Strategic Reasons
• Validation of controls	• Rapid growth, acquisitions
• Identification of risk exposure	• Supply chain effectiveness
• Identification of process improvement initiatives	• System migration
• Compliance with policies and contract	• Increase in spending (production and capital)
• Cost recovery	• Lack of prior audit initiatives
• Improved contract management	• Outsourcing of key functions
• Benchmark against best practices	• Changes in market conditions

BENEFITS OF CONTRACT COMPLIANCE AUDITS

• Achieves cost reduction and cost recovery	• Improves accuracy of supplier transactions and relationships
• Improves procurement and payment processes	• Improves contract structuring for sustained cost reduction
• Improves financial and operational processes	• Improves overall business performance

Below are some suggestions for short-term fixes, which can also aid in developing comprehensive, long-term strategies:

- Notify buyers to use off-line matrices to identify and track engineering changes, pricing agreements and reductions
- Provide purchasing with an awareness training module on the pitfalls of contract errors and how to prevent them
- Use available monitoring reports to identify areas of pricing differences
- Develop more robust monitoring mechanisms for changes related to pricing, currency, non-recurring price, engineering, unit of measure and packaging costs, ensuring evidence of appropriate authorizations in compliance with established processes
- Provide buyers with a simple checklist that indicates the basic, critical documentation that must be retained to meet legal and business requirements

Suggestions for long-term contract compliance strategies include:

Training initiatives

- Define and create training plans based on roles and responsibilities of each position across the procure-to-pay process
- Develop online training material for buyer and support groups to refresh or further develop their skills

Document management

- Design and implement a common management strategy that includes a centralized repository of all contractual procurement-to-pay-related documentation
- Leverage other studies or strategies for lessons learned and implementation of best practices

10 MOST FREQUENT AUDIT OBSERVATIONS

1. Increase executive sponsorship and governance
2. Need to reinforce expectations and enhance communication
3. Need to reassess policies and procedures
4. Need to streamline the process through system enhancements
5. Need to enhance reconciliation, problem resolution and monitoring mechanisms
6. Lack of a centralized, accessible documentation repository
7. Need for education and training
8. Need to improve contract language and standardize terms and conditions
9. Need for vendors to significantly enhance recordkeeping and data access
10. Need to increase transparency of data regarding cost buildups

Purchasing system enhancements

- Enhance or evaluate system functionality that is available but not fully utilized
- Eliminate use of multiple systems or migrate to a more systematic interfaced environment
- Create detailed user guides, making them accessible to all relevant system users
- Develop embedded system controls such as authorization parameters, exception reporting and edit checks

Governance enhancements

- Enhance transparency and distribution of information
- Reassess and revise governing policies
- Reassess and restructure roles and responsibilities to ensure appropriate segregation of duties, accountability and ownership
- Increase management oversight (including plant visits)

WRAPPING UP THE CONVERSATION

Following its contract compliance and cost recovery audit, the company's Chief Procurement Officer wanted a full report.

According to the Finance Director, the audit went well and identified a variety of symptomatic contract errors that deviated from the company's negotiated contract terms and conditions. In addition, approximately five percent of its annual spend was recovered.

In answer to the Purchasing Director's question of how to prevent a recurrence, the Finance Director reported that root causes of several categories of problems were identified, along with process improvement opportunities to increase the accuracy of transactions and allow for sustained cost reduction. Short-term fixes were instituted and ongoing monitoring tools developed to solve the problem of misapplied contract terms that caused overpayment issues.

Additionally, the Chief Procurement Officer reported progress toward improving supplier relationships after receiving a call from its largest supplier noting that long-term contract issues had been resolved and communication restored.

