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Contract Audit:

The Power of Prevention

Extracting increased value out
of your contract audit program



OVERVIEW

Traditionally, supplier contract audits have primarily focused on finding past billing errors and working to recoup funds when overbilling has been identified. However, as companies gain a better understanding and appreciation for the deep intelligence gained through contract audits, they are demanding enhanced audit strategies designed to expose errors sooner and prevent them from happening again. Prevention is key to vastly expanded program value!

In this white paper, “Contract Audit: The Power of Prevention,” we will explore new ways to expand the value delivered by your supplier contract audit program and key steps to help recover lost profit sooner and enhance your bottom line.

Key takeaways include:

- 1. Industry Trends:** An explanation of the evolution of contract compliance
- 2. Pathway to prevention:** Learn the broad spectrum of where overpayment problems originate and how best to identify and most importantly fix the root causes
- 3. From reactive to proactive:** Key steps to building a contract audit program where issues are identified quicker, leading to immediate and sustained cost savings
- 4. Supercharge your results:** Ways to grow the maturity of your contract audit program that will expand value to your company

WHAT IS CONTRACT COMPLIANCE AUDITING?

Before we dive into the contract compliance audit process, audit types that companies should consider and putting a program in place, it's important to define contract compliance auditing.

Every company, big or small, relies on one or many other companies to make money. It's a tightly linked cycle of commerce that can't be avoided. Retailers depend on vendors to produce goods, and vendors depend on retailers to make the sale. Commercial companies rely on suppliers or contractors to provide critical needs and vice versa to keep business afloat.

These important business relationships are commonly solidified when both parties enter into a contract. The terms of the contract drive how the companies will work together to generate profit for all involved. Sounds easy enough, right? Let's take a step back. Before the contract is agreed upon, several phases of negotiation must take place. It's most certainly a give and take with the ultimate goal being favorable terms that will be carried out for the duration of the contract.

While the road to an agreed upon contact can be bumpy, making sure third parties fully deliver on contracted terms can be daunting. Overcharging, invoicing errors, non-compliance with terms and more can cause profit leaks to occur in the process. To mitigate risk and ensure contracts are thorough and effective, as well as ensure that all third parties are performing and invoicing in compliance with negotiated agreements, a contract compliance audit should be considered. And more important, companies should leverage the experience of a skilled and knowledgeable auditing partner.

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INDUSTRY TRENDS

As a whole, trends dictate an actionable or intellectual change in what worked in the past to what's popular now or will be in the immediate future. Let's explore the current shift in gears for contract audit programs.

Switching focus from recovery to prevention

Companies are demanding more value from contract audit programs. They realize the necessity but want more targeted risk mitigation and expanded value. This means the central focus must expand to include the traditional recovery motivation with an equal focus on error correction and prevention.

This evolution of thinking is driving a more proactive approach to contract compliance auditing. Find the problem, fix the problem quickly and put processes in place to prevent the problem from occurring again. Historical recovery remains an important outcome, especially for use as a funding source, but prevention will deliver more value over the long run.

Use of technology to drive enhanced results

Advancements in technology will fundamentally change contract compliance in the very near future. Manual processes and physical labor will be replaced with artificial intelligence and machine learning to automate the ingestion, extraction, normalization and analysis of large amounts of contract data. The impact these tools will have is tremendous and will allow auditors to expand the coverage and value that can be delivered through the contract audit process.

While these benefits will allow the audit team to be more efficient and effective, they will also benefit the clients they serve making audit information easily accessible for internal tracking, trend analysis and other internal needs. Overall technology is poised to add a high level of sophistication to contract compliance auditing in the coming years.

Next generation vs. traditional commercial compliance

A traditional contract compliance audit typically has a central objective of historical recoveries and a secondary objective related to addressing underlying root causes of problems. However, the reality is that too often the corrective action focus is not given enough emphasis or follow through. And more often than not, this results in some lost value opportunity. In addition, since traditional contract audits are generally conducted 3-4 years after the fact, there can be significant loss of full realization of past leakage through the audit settlement process.

Contracts are often written and interpreted by a third party. This creates doubt and differing opinions on the actual intent of the contract. In addition, there are myriad other factors that come into play that can diminish the recoverable value of claims. It's important to note that traditional compliance auditing has a lot to offer, but given its inherent challenges, it does not fully deliver on the total value opportunity in this area. That's where next generation commercial compliance auditing comes in.



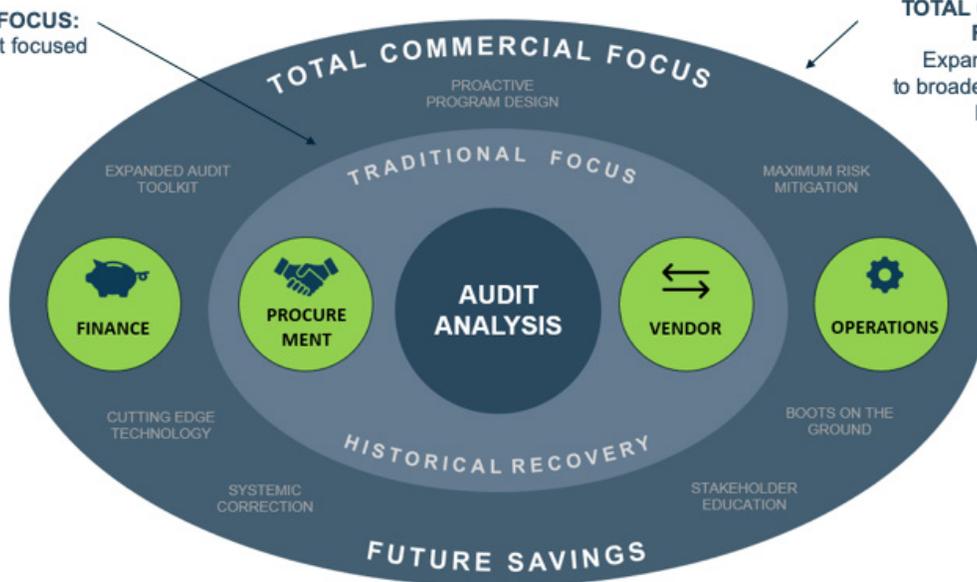


By definition next gen commercial compliance auditing is an expanded service by a skilled audit partner intended to help companies overcome the shortcomings of the traditional contract compliance audit and deliver far greater value in the long run. Here's how:

- ◆ Evolving to a prevention-focused program, one where corrective action becomes a central objective.
- ◆ Taking a more proactive approach and accelerating timelines whenever possible.
- ◆ Incorporating new, more targeted methodologies which are designed to address the blind spots of the traditional compliance audit.
- ◆ Utilizing technology to reach broader and deeper than ever before.
- ◆ Capturing learnings and educating clients on why problems occur and how to avoid them in the future.

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TRADITIONAL FOCUS:
Powerful, contract focused
view



TOTAL COMMERCIAL FOCUS:
Expands Coverage
to broader range of value
leakage

PATHWAY TO PREVENTION

Proactively addressing total commercial compliance

In commercial compliance audit, auditors measure success based on the total value proposition – the value that comes from delivering both the historical cost recovery as well as the future cost savings resulting from audit initiated corrective actions. Traditional compliance audit evaluates the vendor billing history against the procurement contract with the primary deliverable of historical recoveries. There are numerous lessons learned from the traditional approach, but unfortunately this approach is not all-encompassing, and there are several known blind spots. In particular, there is little focus on leakage resulting from the root causes that originate in operations or finance in a traditional audit – two very important functional areas when it comes to ensuring billing and payment errors are prevented.

Commercial compliance auditing expands the visibility aperture, so rather than focusing just on the traditional areas, the focus is expanded for increased visibility. This moves beyond the narrow focus on contracts and vendors and includes review of the high-risk elements within operations and finance.

Total Commercial Focus Example

When broken down into its most simplistic form, an invoice multiplies price times quantity to arrive at the amount due. But, it's very difficult to ensure the accuracy of the quantity in a traditional compliance audit. Typically, 80% of the compliance audit test procedures focus on the price side of the billing equation with 20% on the quantity side. This is a prominent limitation for contract compliance auditing and calls for a specialized audit approach focused on quantity assurance to improve billing accuracy.

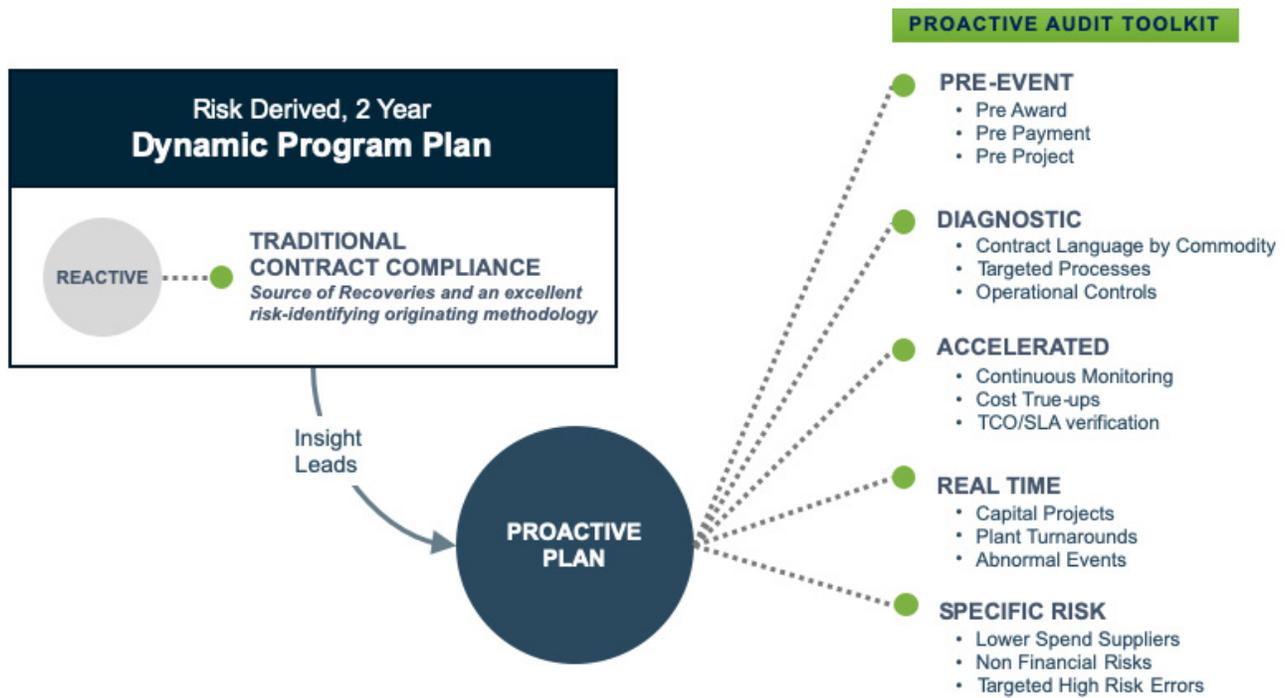
FROM REACTIVE TO PROACTIVE

The tools you need to get ahead of the curve

Adopting next generation contract compliance auditing starts the shift to a proactive mindset, but this doesn't mean traditional contract compliance with a reactive focus becomes obsolete. For a variety of reasons, traditional contract compliance will always form the central audit approach. Most importantly, the recoveries are still a significant source of value and an excellent funding mechanism. So, even though the traditional approach is reactive, it works hand in hand with proactive methodologies.

Outlined below is a proactive audit type toolkit:

- ◆ Pre-event audits – the most proactive approach of them all
 - Addresses the risk before revenue leakage occurs
 - Auditors may work on-site to evaluate invoices prior to approval and payment
 - Examples include pre-contract award and pre-project procedures
- ◆ Diagnostic audits
 - Addresses targeted known problem areas
 - Deliverable is the strengthened or corrective action addressed proactively
 - Examples include process or controls design audits, contract language and diagnostic audits – by category
- ◆ Accelerated audits
 - Early audit and corrective action for known high risk areas such as:
 - o high risk supplier – quarterly continuous monitoring
 - o high risk contract provisions – cost true ups/verifications
 - o difficult to evaluate provisions – TCO or SLA provisions



- ◆ Real-time audits
 - Boots on the ground activity monitoring
 - Useful during high-volume or chaotic work environments
- ◆ Specific risk audits
 - Useful in addressing technology enabled low-hanging fruit, such as:
 - o lower spend suppliers – targeted risk using contract intelligence
 - o targeted high-risk errors – high risk provisions across your supplier base; e.g., per diem, rebates

There are a variety of techniques that address risk not directly evaluated in a traditional contract compliance audit. Through these targeted expanded procedures, companies are able to address traditional compliance blind spots and other high-return opportunities.



SUPERCHARGE YOUR RESULTS

A well designed and fully realized program management model yields higher program value

Commercial compliance auditing offers many opportunities to boost audit program value. Companies that want to seriously supercharge their audit program value must understand the importance of a well-designed and mature program management structure and experienced compliance audit partner. These programs are complex and multifaceted. There are many pitfalls awaiting those who are unaware, and an inexperienced audit firm can create a lot of havoc if they don't have a sound approach to managing execution risk. Two similar companies embarking on contract compliance auditing processes may achieve significantly different results based on their program management maturity. And underperforming programs are not an option, they want the full benefit. Auditors must take into account:

- ◆ Audits are focused on the largest most strategic and complex business supplier relationships
- ◆ Contracts are complex and interpretive
- ◆ There are multiple stakeholders, with different motivations and points of view, both internally and externally
- ◆ And, lastly, audits can be a daunting task to start

Strong governance is key to creating a mature audit program for your company and provides fuel to supercharge results.

We classify maturity in five key strategies:

- ◆ Goals and objectives – A simple yet sometimes overlooked key component – defining success and key performance metrics
- ◆ Governance structure – A strong executive sponsor, and a clearly defined decision-making protocol are key
- ◆ Culture – the organization must be aligned to support and promote the program objectives
- ◆ Process – not just the standard process, but also exception processes, well defined, documented and supported
- ◆ Technology – what and how it will be utilized to advance program capabilities

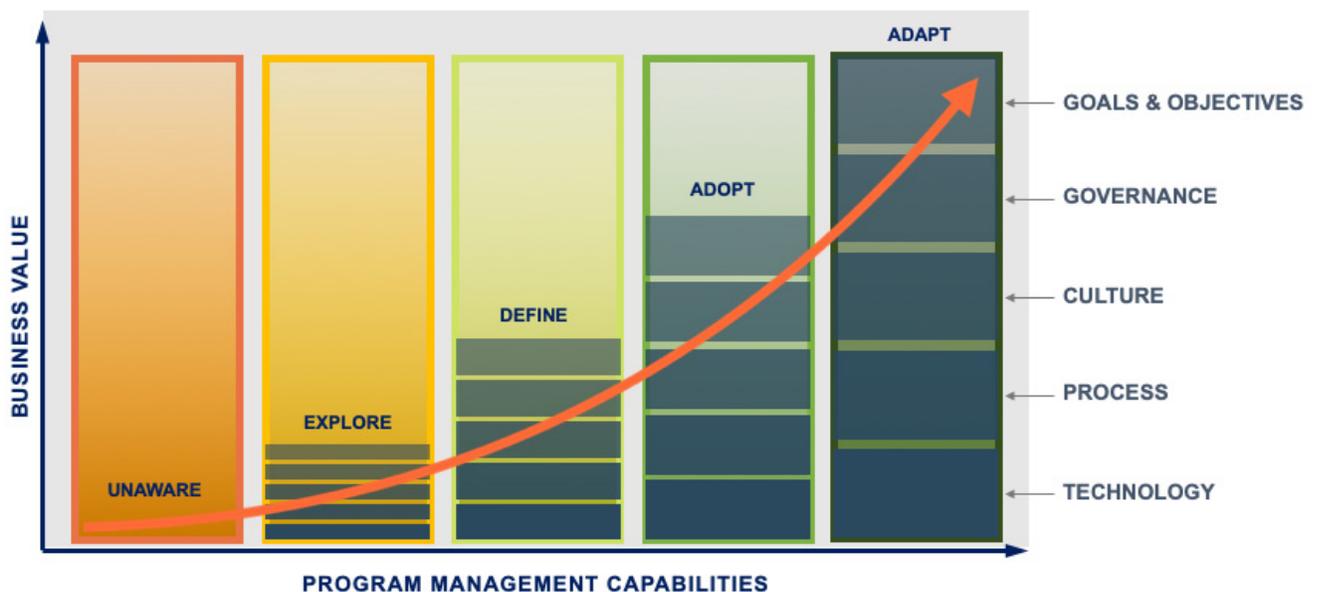
Figuring out where your business may fit in the maturity model can be tricky. It requires that you ask some questions to understand where you are in the process towards strong governance:

- ◆ What are the audit program objectives? Surprisingly this isn't always clear.
- ◆ Do you budget key metrics and measure success against your audit program objectives?
- ◆ Is there visibility and expressed support of key executives aligned to audit program goals?
- ◆ Are key decision-making protocols well defined and documented?
- ◆ Are key program decision makers held accountable and/or incentivized for audit program results?
- ◆ Is there a top to bottom organizational alignment around program objectives?
- ◆ Are key processes documented and frequently reviewed to identify areas for improvement?
- ◆ How is technology being leveraged to advance program objectives?

Moving towards a maturity model of contract compliance can certainly seem like you are juggling many moving parts, and you may be unclear on how people, process and technology can work together to accomplish your goals.

The key is creating alignment of key program capabilities. Unfortunately, it's not uncommon to have misalignment on some key aspects of program management and this can have a significant impact on results.

An experienced audit service provider in place will help you build a robust program that will mature and produce significant results.





SUMMARY

Now is the time to start transforming your contract compliance program! Below is a summary of actionable steps you can take to get the most out of your compliance audit program:

- 1.** Begin by evaluating your goals against your current contract compliance program and governance. Is there more value to be gained from new ways of thinking?
- 2.** Consider high-risk vendors or operations for proactive and real-time audits.
- 3.** Leverage technology to enhance data-driven decision making and smarter programs.
- 4.** Develop a program to maximize value, prevent future leakage, and supercharge your results.

Consider your options for getting the professional guidance needed to help you achieve your goals. PRGX is on the cutting edge of development with many of these emerging trends and ready to partner with companies to perform contract compliance audits and help realize the power of prevention.

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