Contract Compliance Auditing – Recoveries and Much More
## Contents

Introduction .................................................................................................................................................. 3

Why perform contract compliance audits? .................................................................................................. 4
  Cost Recovery ................................................................................................................................................ 4
  Process Improvement .................................................................................................................................. 5
  Fraud Prevention and Detection ................................................................................................................... 5
  Risk Management ....................................................................................................................................... 5

Which contracts should be audited? ............................................................................................................ 7
  Global Exposures ....................................................................................................................................... 8

How do you establish effective contract audit objectives? ........................................................................... 9

When should you perform a contract audit? ................................................................................................. 9
  Control Audit ............................................................................................................................................ 10
  Recovery Audit ......................................................................................................................................... 10

Who should participate on a contract compliance audit team? ................................................................. 11

What are the essential elements to a successful contract compliance audit? ............................................ 13
  Executive Level Support for the Audit ....................................................................................................... 13
  Timely and Effective Communication ...................................................................................................... 14
  Audit Planning and Execution .................................................................................................................... 15

Summary and Conclusions ........................................................................................................................ 15
Introduction

In today’s business environment, an opportunity to save money, reduce risk, identify and implement process improvements and improve controls for a relatively small investment should be enthusiastically embraced. Every well managed company performs contract compliance audits, but are they realizing maximum benefit from the effort?

Full scope contract compliance auditing is an analytical review that determines whether the contractor is executing the terms of the agreement and delivering goods and services to the customer in the appropriate manner and at the agreed net cost. Traditionally, the audit is performed by the customer’s Internal Audit department or an external audit consultant.

This article addresses some of the most frequently asked questions regarding contract compliance auditing:

1) Why perform contract compliance audits?
2) Which contracts should be audited?
3) How do you establish effective contract audit objectives?
4) When should you perform a contract audit?
5) Who should participate on a contract compliance audit team?
6) What are the essential elements of a successful contract compliance audit?
Why perform contract compliance audits?

Performing a contract compliance audit ensures that the agreement is being executed in accordance with the intent of all parties to the contract. Net benefits include cost recoveries, process improvement savings, fraud prevention and detection and identification of hidden risk. Contract compliance audits also satisfy the need to appropriately manage risk for companies.

There are many benefits realized in performing effective contract compliance audit reviews:

- Cost recovery
- Identify, develop and implement process improvements
- Elevate fraud awareness and deter fraudulent activity
- Manage contract areas of risk

Cost Recovery

The most common purpose for conducting a contract audit is to ensure that the contractor has not overcharged per the pricing structure in the contract and that goods and services were received in a timely manner. Many contract audits discover overpayment issues, clerical errors and missed credits and discounts. These can result in material recoveries for organizations that institute regular reviews of contracts, as noted in the examples (on page 6). If overpayment issues are detected, the review identifies the root cause, quantifies the overcharge and establishes a basis for negotiating recovery from the contractor. As noted, the level of recoveries depends on complexity of the agreement, materiality of spend and effectiveness of both the contractor and customer control environment.

Factors That Impact Contract Audit Recoveries

Annually, corporate and government contract audit teams review hundreds of billions of dollars in spend, identify tens of billions of dollars in audit issues and recover billions of dollars in overpayments. A recent search of contract audit activity disclosed:

- External service provider audits $700 billion annually with savings up to 5% of the contract spend
- External audit firm saves over $1 billion for clients annually
- Government contract spending of $526 billion in Fiscal Year (FY) 2008 [Source: USSpending.gov]
- Defense Contract Audit Agency (DCAA) FY 2008 audited $138 billion in contracts and $313 billion in forward pricing proposals delivering a net savings of $3.3 billion

Factors that determine the recovery potential for contract audits:

- Contract type and complexity (Cost plus, Time and materials, Fixed fee, Lump sum)
- Level of spend
- Relative control of contractor processes in generating invoices and remitting credits
- Quality of customer review
**Process Improvement**
Review of processes the contractor uses to deliver goods and services and compile invoice charges may reveal procedural or communication issues between the customer and the contractor, or internally within the customer or the contractor. Pursuing mutual opportunities to execute in a more efficient manner can realize material cost savings. Improved productivity over time strengthens the customer/contractor relationship and promotes collaboration on identifying future cost savings opportunities.

**Fraud Prevention and Detection**
Timely and regular reviews put the contractor on notice and provide a mitigating control by heightening the contractor’s awareness that all charges will be scrutinized. This awareness diminishes the potential for inadvertent overcharges and deters fraudulent activity.

**Risk Management**
Performing the audit ensures areas of risk identified in the agreement are being effectively managed. Specifically, an audit ensures that:

- Regulated activities are being performed according to statute or accepted standards (environmental health and safety, background checks, etc.)
- Applicable fees, permits or taxes are being remitted by the contractor in a timely manner
- Contractor’s insurance limits the customer’s exposure to loss
- Sub-contracted activity has been adequately reviewed and approved prior to work being initiated and is being effectively managed and reported
- Suppliers and sub-contractors are being paid for completed services in a timely manner
- Appropriate control, care and disposition is evident for customer owned assets, supplies and materials
- All related work product (construction, models, software, plans, drawings, etc.) has been completed and delivered to the customer prior to close out and release of retention payments

All of these benefits fall under the umbrella of effectively managing contractual relationships for an organization. Therefore, managing all types of risk associated with the contract (overpayment, loss, inefficiency, missed opportunities, etc.) should be the primary focus of an organization’s contract audit efforts. Audit planning should incorporate not only the obvious objective of determining whether controls over assets and prevention of loss are adequate and effective or whether overpayments have been made to the contractor, but should also address organization risk priorities as defined in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework that established a comprehensive strategy of awareness and management of risk.
The COSO Enterprise Risk Management (ERM) – Integrated Framework Executive Summary categorizes organization objectives as follows:

- Strategic – high-level goals, aligned with and supporting its mission
- Operations – effective and efficient use of its resources
- Reporting – reliability of reporting
- Compliance – with applicable laws and regulations

By establishing a risk-based framework as the foundation of the contract audit process, organizations can maximize the coverage and benefits obtained from the effort. Utilizing a risk-based strategy also ensures that organizations do not miss exposure areas or opportunities and suffer significant loss.

Examples of Contract Audit Findings

A. An Oil and Gas company utilized a related entity as rig contractor for a joint venture project. Daily rig rates billed exceeded local market rig rates over a two year period by more than $1 million.

B. A Contractor with a cost plus contract for services overcharged:
   - Project costs
   - Office lease
   - Bonus accrual
   - Mark-up

   Gross audit claims for a one year period represented 4% of total billed cost.

C. Fee, escalation and mark-up calculation errors for a service contractor resulted in overcharges of approximately $1.7 million.

(Representative of audit findings during author’s career)
Which contracts should be audited?
The annual contract audit plan should specifically satisfy the organization’s risk appetite as defined in the Enterprise Risk Management (ERM) strategy.

Many organizations have not initiated or fully implemented an Enterprise Risk Management strategy. For those organizations, it is essential that Executive Management be introduced to the framework and that they begin to appreciate the consequences, both in exposure to loss and missed opportunities, associated with failure to adopt a risk based approach to management. For organizations that identify certain contract activity as a risk exposure, inclusion of those audits in the annual audit plan will allow effective prioritization, execution and reporting of contract audit results.

Other Considerations of Significant Organization Risk
Contract audits that focus solely on pricing and cost recovery issues will verify contract cost to billings, but there are other considerations of risk as exemplified by:

Peanut Corporation of America (PCA), a peanut processing company and maker of peanut butter for bulk distribution to institutions, food service industries, and private label food companies, today announced a voluntary recall of peanut butter produced in its Blakely, Georgia processing facility because it has the potential to be contaminated with Salmonella.

**Wall Street Journal** (March 19, 2009) *Food Industry Safety Inspections Challenged*
Rep. Bart Stupak (D., Mich.) chairman of the investigations subcommittee, questioned how dozens of food companies that bought peanut paste and other ingredients from Peanut Corp. failed to pick up the problems. Part of the reason, Rep. Stupak said, is that they relied on safety audits by inspectors who were hired by Peanut Corp. Peanut Corp.’s private inspector, a company called AIB, awarded it a certificate of achievement in 2008 for “superior” quality at the Texas plant...

At least one food company that used its own auditors, Nestle, decided not to do business with Peanut Corp...

Kellogg lost $70 million in the salmonella outbreak after it had to recall millions of packages of peanut butter crackers and cookies.

The total downstream cost of the recall, governmental agency cost, associated lawsuits and lost sales could reach several billion dollars. The US Food and Drug Administration online Product Recall List on March 20, 2009 had 3883 human and pet product entries.

Traditionally, annual contract audit plans were focused primarily if not exclusively on material dollar value of spend to the contractor. Since the advent of ERM, more organizations are looking beyond level of spend as the defining criteria to prioritize an audit. Recent global events in the financial markets and in particular exposure to financing risk have proven that a comprehensive risk management strategy is essential.
Another recent example of an opportunity to manage risk is from the food manufacturing industry (see previous page). One company that utilized its own audit group to assess supplier manufacturing quality was able to avoid tainted supplies and subsequent recall issues.

There are many factors worthy of audit beyond the regular pricing and cost recovery considerations, including:

- Quality and safety of product
- Protecting or enhancing an organization’s reputation
- Long-term viability of strategic sourcing partners
- Environmental concerns, etc.

The list is long and depends upon the strategic mission and objectives of the organization. Each organization needs to factor its own risk appetite into developing a prioritization of target contract audits. Supply Chain product quality issues demonstrate an organization’s exposure to material loss. Lack of time or experience is not a valid justification to delay or forego contract audits that are considered high risk priorities by senior management.

**Global Exposures**

As organizations begin to rely on globalization of supply chain activities to improve efficiency and reduce cost, management of risk relative to contract compliance auditing becomes even more complex. Awareness of changing foreign regulations, standards and reporting, product quality and safety, and environmental sustainability are significant considerations for executive management. The *PRTM Report on Global Supply Chain Trends 2008-2010* estimates that more than 50% of manufacturing will be globalized by 2010. The report of surveyed companies also shows that leading organizations in globalizing supply chain activity believe increased frequency of on-site audits is one of the top four risk mitigation strategies.
How do you establish effective contract audit objectives?

A collaborative effort between customer’s management, support staff and the audit team helps ensure objectives are comprehensive. The objectives should include all relevant risk, control and operational concerns or issues for that contract, including subcontractor or supplier activities that relate to the agreement.

Contracts identified in the risk review (that meet risk appetite standards) which are worthy of an audit should be analyzed to identify areas of exposure and define the objectives for testing. This can be most effectively executed with a collaborative effort of the parties involved in managing contractor activity and the audit team. This is one of the most frequently missed opportunities to maximize benefit from the effort.

The customer’s management team understands the working relationship, historical issues, obstacles and solutions implemented during the scope period. The customer’s support services group executed the agreement and paid the contractor billings. The audit team has the requisite understanding of Executive Management’s risk appetite, control points and analytical skills to review the contractor processes, detailed transactions and supporting documentation to identify areas of concern and material recovery issues.

While it is the audit team’s responsibility to draft the objectives, it is essential that the customer’s management team and support services be made aware of the audit opportunity and allowed to provide input and background information to assist in developing comprehensive and complete objectives. This input ensures that the focus of the review addresses all of the potential benefits, including cost recovery, process improvement, risk management and opportunity recognition.

The management team’s review of the completed objectives ensures clarity of purpose and provides support to the effort. Now the contractor can be notified and brought on board. It should be clearly stated to the contractor that the audit team has the full support of customer’s Executive Management. This establishes the appropriate tone and expectations for the review and communicates the customer’s intent to work with the contractor in a collaborative manner.

When should you perform a contract audit?

Timing of an audit should align both the objective of the review and relative leverage of the customer in obtaining timely resolution and satisfaction of any issues disclosed during the audit.

Negotiating and executing basic contract terms should include appropriate due diligence to ensure that the contractor can meet the customer’s minimum data capture standards and process controls. Appropriate language regarding right to audit must be included. Audits should be initiated when the customer’s relative leverage to change processes or recover overpayments or missed discounts and rebates is strong. Looking at a traditional cumulative spend curve for a contract (see below), there is an optimal range to execute an audit. The boundaries, objective and approach are slightly different through the range.
**Control Audit**

Typically, auditing during the early cumulative spend period gives the customer an understanding of the contractor systems, controls and supporting documentation being generated to support costs billed to the customer. An audit at this end of the spectrum could be labeled a "Control Audit" as the objective is to ascertain the quality of the Contractor (and Sub-contractor) controls and systems for the duration of the contract. Most audit issues and recommendations relate to improving communication, streamlining processes or avoiding future overspend.

**Recovery Audit**

Audits executed toward the end of the cumulative spend spectrum are usually considered “Recovery Audits”. The objectives of a recovery audit are to determine whether any contractor charges are not valid, do not relate to the project, were duplicated and paid on a prior invoice or are overstated. Execution and completion of a Recovery Audit needs to occur while the customer still has leverage to collect overpayment amounts from the contractor. Future projects or contracts with the contractor also provide opportunities for process improvement as well as negotiating recovery of overpayments.

Focusing exclusively on cost recovery may neglect the risk exposures inherent in the contract. In such cases, audit teams searching only for monetary recoveries will likely forego process improvements or operational opportunities that could provide several times more value to the organization than the net realized dollars brought to the bottom line in recoveries. The relative cost of adding risk related objectives to the review is not significant versus the alternative of continuing to make the same costly errors, exposing the organization to loss or failing to take advantage of a material opportunity.
Who should participate on a contract compliance audit team?
The audit team should consist of the “correct” blend of experience, technical expertise and awareness of relevant control issues to perform the contract audit in a competent and professional manner. This may include utilization of external contract audit resources.

Ideally, contract compliance audits should be lead by individuals with significant contract audit experience and a familiarity with operations, processes and culture. Many of the benefits of performing an audit are realized only when competent and qualified auditors perform the work. With contract auditing, the auditor is acting as a service provider to the “Client” groups within the customer organization, namely the Support Services and Operations groups. Auditor strengths, such as identifying issues and determining whether they are material control concerns, overpayments, or potential fraudulent activities are essential in this effort. Analysis of test results provides the biggest contribution a seasoned audit professional can provide their “Client” organization. Defining the root cause and having the experience and understanding of the Client’s culture allows the auditor to recommend cost effective and practical solutions as well as having a vision of how to implement the proposed solution.

There are occasions that Internal Auditors may not have the technical expertise to understand or comprehend complex technical, scientific or manufacturing processes. In those instances, organizations may require operational representatives join the team, to ensure the review retains the quality and comprehensive treatment deserved. In addition, there are firms that specialize in auditing for fraudulent activities within contractual relationships. If a potential for fraud exists, it is best to turn to forensic accounting experts and fraud investigators that have a proven track record of dealing with these issues. (The use of external service providers is addressed in the Institute of Internal Auditors Practice Advisory Standard 1210.A1-1 and Engagement Resource Allocation Standard 2230-1).

Companies that have resource and experience constraints can complete required audits by:

- Modifying scope to complete essential review on all defined audits and only perform comprehensive and complete testing when initial testing indicates there are areas of concern
- Recruiting resources from operations to augment the audit teams and have these resources managed by experienced auditors
- Adding additional resources to the audit department and rotate the new auditors through several types of contract audits to help them develop at an accelerated rate
- Utilizing an external contract compliance audit provider

Each of the alternatives has relative strengths and weaknesses. Organizations need to determine whether the alternatives are realistic given specific resource constraints and will allow quality audits to be performed and completed in a reasonable amount of time.
Limiting scope or performing selected testing has drawbacks, including missed identification of significant audit issues, cost saving opportunities or fraudulent activity. Sample selection techniques should be scrutinized to ensure that all material costs, control points and risk exposures are adequately identified and reviewed during the audit.

Typically, resource constraints within operations or the audit department limit extensive use of operational expertise, and the time and cost required to train new auditors is a significant commitment and investment. Many organizations do not have the luxury of retaining a highly qualified staff due to high turnover. Frequently, the best and brightest within the Internal Audit department move on to other positions within the organization. When that occurs, many organizations look to outside service providers to perform contract audits.

Regardless of whether internal or external resources are used for contract audit work, organizations beginning at the executive level must be willing to support the effort and embrace change to fully realize process improvements identified during the audit.
What are the essential elements to a successful contract compliance audit?

Executive Level support, timely and effective communication and audit planning and execution are essential to executing effective contract audits.

Customer Supply Chain or Operations managers and Contractor Finance or Operations executives can recount horror stories related to contract compliance audits they have been involved with in the past. Few share glowing accounts of an audit that was efficient, effective and helped them improve processes and realize material bottom-line savings. Many contract audit efforts are found to be wanting, because the review lacks one or more essential elements for success:

- Appropriate level of Executive support throughout the engagement
- Cost versus Benefit mindset during execution of the audit
- Structured communication with all involved parties (Internal and Contractor)
- Client and Contractor cooperation
- Collaborative effort in resolving issues and implementing change to ensure future improvement
- Effective right to audit clause
- Complete and clear audit objectives
- Correct pacing of the work – non-intrusive to both Client and Contractor

Most of the items listed above seem intuitively obvious, but when disregarded or not properly executed cause significant issues and often derail audits or cause friction and resentment directed toward the audit team from both the Client and Contractor organizations.

There exists a natural balance in optimizing the relationship between the customer and the contractor. Many audits do not effectively account for the true net cost benefit and long term impact of their findings and recommendations. Typically, this results in a less than optimal environment to achieve the true balance between cost, control and profit for all of the parties involved in executing the contract. The items highlighted below offer the first step in promoting a “win/win” relationship for all participants in the contract audit process.

Executive Level Support for the Audit

Client Executive Management’s support of the engagement and expectations that the exercise will realize cost recoveries and identify opportunities for improvement sets the appropriate tone for the review. Management should also appreciate the cost or negative impact that could result in foregoing or failing to execute effective audits (see next page). Audit recommendations should demonstrate understanding of the risk management culture of the organization and appropriate consideration of the net cost/benefit for both the Client and Contractor. Likewise, Client Operations and Support Services need to realize that the Audit Team is working to attain the best end result for their organization.
Executive support and participation in implementing change is critical to realizing bottom line immediate and long term benefits.

**Participants in Contract Audits**

**Client Operations**
Includes Executive Management

**Client Support Services**
Supply Chain and Accounts Payable

**Contractor**
Executives, Accounting, Operations and Sales

+ **Audit Team***
Internal Audit or External Consultant

*Must appreciate the relationships involved in the contract.

**Timely and Effective Communication**

The core principal of timely and effective communication to all related parties goes a long way to ensuring success of contract audits. Getting both the Client and Contractor to work in a collaborative and cooperative manner significantly increases the probability that the effort will result in a “win/win” situation for all parties. Often, the underlying initial tone of the audit from either the Client (wanting to find significant overpayments or poor practices and prove a point) or the Contractor (being obstructionist or not forthcoming with relevant information in an attempt to stall or sabotage the audit) can prevent any attempt to deliver a quality review. Most material realized savings are a result of improved communication between all groups involved in executing the contractual agreement.

**Costs of “Failure” to Execute Effective Contract Audits**

- Higher net cost
- Missed overpayments to vendors
- Fraud losses
- Higher product defect rates
- Potential disruption to production
- Product recalls
- Reputational damage
- Unpaid subcontractor, supplier and tax obligations
- Insurance losses
- Litigation expense
Audit Planning and Execution

It is essential for all parties of the contract to realize from the initiation of the agreement that it is a best practice activity to regularly perform contract audits. Having a clear and concise audit clause establishes the basic scope of work, standards for acceptable data, supporting documentation and timing for execution of the audit. If all parties to the agreement clearly understand the objectives of the review, work within reasonable timelines to set up, execute, analyze and discuss audit findings, the probability that the end result will be a success for all participants dramatically increases. Audit teams that deal with results in an objective, factual manner earn respect of all involved participants and will likely provide balanced “real world” recommendations that will be implemented and realize both cost savings and enhanced productivity for the Client and Contractor.

Summary and Conclusions

Over the last thirty years, Internal Auditing has taken on several new challenges and evolved to become a significant resource to Executive Management. Recently, the emphasis on prevailing issues such as accuracy in financial reporting demanded energy and focus within organizations to the detriment of development and execution of comprehensive contract audit plans. Today, many audit departments and organizations struggle with a skill or resource gap in executing effective contract audits and maximizing the value from those efforts. Executives of leading edge companies value the partnering of internal core competence and external audit expertise to maximize the coverage and impact of contract compliance audits to effectively execute their Enterprise Risk Management strategy and maintain global competitive advantage.
About Balance Risk

Balance Risk works with Executive Management to ensure that their organization can effectively respond to events and opportunities that define competitive advantage versus their peers. Balance Risk adds value by optimizing the balance between risk and control while managing cost. For more information, go to www.balancerisk.com.

About the Author

As President of Balance Risk, Robert Serocki has 27 years of experience in the Oil and Gas, Telecommunication, Manufacturing, Utility and Service industries. Robert has helped clients successfully recover over $22 million in overpayments. As an Internal Auditor, Robert managed domestic and international audit teams for exploration, production and joint venture audits. As a consultant and control analyst, Robert has performed detail process flow reviews and developed control self-assessments for management. He has a Masters Degree in International Finance from University of Southern California, a Bachelor of Science Degree in Accounting from California State University, Long Beach and obtained Certification as an Internal Auditor in 1984. For questions or comments, please email: rserocki@balancerisk.com.