PUBLIC SECTOR ETHICS AND CONTRACT COMPLIANCE AUDITS

Kimberly Sangster and John Venti*

ABSTRACT. Performing audits of contracts are important tools to ensure that the purpose for the agreement or the performance of a contract actually occurs. Audits will validate and measure processes that are in place, identify those that require further enhancement, and isolate weaknesses that may lead to fraud, collusion, and conflicts of interest. Contract compliance monitoring is as necessary an element to maintain an open and fair procurement process, as the implementation of ethics policies. Audits conducted after problems are uncovered are reactionary. The goal is to identify weaknesses and inform management of situations that may lead to ethical conflicts and issues before problems develop.

INTRODUCTION

Both the public and private sectors have encountered increasing pressure to reduce costs while simultaneously expanding the level of service. Stockholders and taxpayers demand that those charged with running either public or private institutions do so in a responsible, fiduciary and cost efficient manner. Public institutions are particularly scrutinized in its procurement function due to the public trust embodied by its contracting authority. Statutory or regulatory authority promulgates ethical standards in the solicitation process, however in the contract administration process; there can be a divide between the expectation of that public trust and the management of the contract.

----

* *Kimberly Sangster, CPPB, CPPO and John Venti C.P.M. are respectively Senior Vice President and Procurement Manager for the School District of Philadelphia. Their major responsibilities and efforts have been targeted towards improving the supply chain process and implementing strategic sourcing for the School District of Philadelphia.*

Considering the above, it is incumbent upon management to ensure that the funds spent for goods and services provide a return on an investment by increasing productivity and efficiency. The savings generated add to the bottom line by directly or indirectly lowering overall costs which provide additional revenue to meet other needs of the organization.

Periodically an organization will contract with a firm to provide for materials, supplies, or services. The practice of employing ethical standards in the vetting of suppliers, and the subsequent awarding of contract is a public expectation. Contract audits can provide transparency to the procurement process and confirm that the public trust is fulfilled. To ensure that the obligations of a contract are being met, contract audits should take place on a regular basis throughout the term of the contract. The audits will allow for the organization to assess whether its controls, practices, processes, and procedures are adequate and effective.

Contract auditing for goods and services allows an organization to verify and validate that the conditions of the contract are actually being met. Contract audits should determine compliance with the contractual terms and conditions of the agreement and the effectiveness of the organization's controls. Many times performance problems related to the contract exceed the issues related to overcharges.

BACKGROUND INFORMATION

Various types of contracts exist and each pose more or less risks in ensuring that the reasons for issuing a contract are being met. The reasons may include:

1. Providing or fulfilling an ongoing need in support of engineering, operations, or the organization's mission;
2. An opportunity to control costs;
3. Providing controls for the prevention of fraud and corruption;
4. A means to allow procurement to become more proactive by issuing bids, quotations, or requests for proposals (RFP) for repetitively ordered commodities or services that result in a large number of transactions. It is more efficient for the organization to

5. allow the user to order such items directly via a blanket order contract.

Some of the different contracts and their exposures or attributes include:

1. Firm fixed price - prices are fixed for the term of the agreement. Depending on the contract's length, the supplier assumes more risk in material and labor costs;
2. Fixed price with incentive – controlling their costs allows the supplier to share in the profits via pre-determined targets or formulas;
3. Fixed price with adjustment/escalation – for contracts involving a long period of time and large amounts of money, a supplier is usually reluctant to quote firm prices due to certain risks such as inflation. In such cases, the adjustment/ escalation clause provides for both upward and downward changes in price as a result of either material or labor costs. Adjustment or escalation clauses are typically tied to recognized indices.
4. Cost-plus with incentive fee – similar to the fixed price with incentive, if costs are below target, both parties share in the savings. Conversely, the supplier can lose its incentive fee but still recover its costs if it exceeds the target;
5. Cost-plus with fixed fee – reimburses the supplier for its costs plus a negotiated fixed fee;
6. Cost-plus a percentage of costs – unless it is properly setup and controlled, it could lead to higher overall costs and resulting profit to the supplier.

In the case of the School District of Philadelphia, approximately $160 million are spent annually in support of the academic areas including the purchase of textbooks, instructional aids, classroom and office supplies, maintenance, repair and operating supplies (MRO), school buses and associated services, various and sundry services to support operations, or classroom instructions, etc.

Reasons to Perform Contract Audits

Procurement Officers are charged with oversight of the procurement process and are perceived to have a social and fiduciary responsibility to maintain the integrity of the process. Some organizations focus primarily on the solicitation process, without attention to contract management. Furthermore, purchasing staff often rely upon the suppliers for contract compliance without knowledge of the suppliers' ethics policies or internal controls.

In order for an organization to provide control and oversight, contract auditing should be performed periodically by the organization's auditing department, or if one does not exist, via a contracted auditing firm. The reasons to perform contract reviews and audits include:

1. Verifying that the reason(s) for issuing the contract or that the savings envisioned as part of the contract are being realized or met. Many times a contract will be put into place but contract reviews are not performed. The organization should have a process in place to verify that pertinent issues are being met such as the obligations, terms and conditions, and that invoices are prepared according to the contract;
2. Deterring fraud and fraudulent activities - fraud and collusion can occur anywhere within an organization and could happen in several ways by:
    - Close business dealings or social involvement on a frequent basis with employees and contractors,
    - Duplicate payments with or without an employee's involvement,
    - Companies submitting bids under different names,
    - Collusive bidding, bid rigging and price fixing among suppliers,
    - Fraud in the solicitation, evaluation and award of contracts.

A competitive bid process has inherent controls that afford reduced risk and opportunities for fraud and collusion to occur. However, procurement officers and employees should remain aware of situations where the same supplier is the only one repetitively bid on and receive a contract for the same commodities. This could indicate collusive bidding by suppliers where they only bid on contracts for a particular local or geographical area.

METHODS

Audit Strategy

There are varying types of audits that may be used in contract compliance testing. They include: financial audits, social responsibility audits, those that focus on internal controls and procedures, and audits defined by the Sarbanes Oxley legislation, which encompasses a myriad of fiduciary concerns. Supplier performance evaluations are another tool where a procurement official can review the suppliers' performance in terms of meeting the requirements of the contract.

With the intent to avert fraud and collusion, and to maintain the public trust, a well designed audit will address all of the critical steps needed for contract compliance by evaluating the entire procurement process,

To conduct a thorough contract audit will require inquiry into processes, systems, procedures and documents to provide transparency in the contracting process. Sufficient personnel resources are necessary to ensure a successful contract audit. Topics and questions to be considered include the following:

- Are the obligations of the contract being met? Having an ethics policy in place for procurement staff or suppliers does not verify that the obligations of a contract are being met;
- Do invoices match and accurately reflect the billings allowed in accordance with the terms of the contract, including charges from subcontractors or other suppliers, etc.;
- Do contracts, whether bilateral or unilateral such as a purchase order contracts, where an offer to buy and an agreement to sell exists, should include an audit provision.

Ideally the audit team should include representatives thoroughly familiar with the contract and representatives from other departments that have the expertise or skills to conduct a meaningful review of the contract. In some cases an organization may need to contract with a company that has expertise in a particular area or commodity.

Audit clauses should allow for the organization to perform audits of the contract during its term and for a period of time, approximately 5 years, after the expiration of the contract. The audit clause should specify that the audit should include any and all aspects of the Contractor's performance under the contract, including but not limited to its billings and invoices, all cancelled checks, work papers, books, records, vouchers, other materials upon which the invoices or expenditures are based, and any and all documentation in support of expenditures or fees incurred pursuant to the contract. The audit clause should specify that the Contractor shall cooperate with the organization and allow meetings with the contractor's staff members. The audit clause should specify a records retention period of approximately 5 years or that specified by applicable law.

Compliance Testing Via Statistical Sampling

Based on the spend thresholds, which may require an invitation for bid or request for proposal, and the size of the public organization, there may be literally hundreds of contracts issued on an annual basis. The public's expectation of fiscal accountability and ethical practices is not limited to a dollar threshold, yet an organization's ability to ensure compliance with all contracts can be difficult due to the resource limitations and the time required to conduct an audit. The use of an audit technique such as statistical sampling can be a tool to measure compliance and expose ethical conflicts without straining the organization's resources.

Statistical sampling of transactions is well established in auditing. The goal of using statistical methods in auditing is to form an opinion about the entire population using an unbiased statistically valid sampling technique. The goal of sampling is to achieve audit efficiency in terms of time and cost. The key consideration in designing compliance tests of transaction details is that the sample must be representative of the entire population.

Probability sampling techniques include simple random sampling, systematic random sampling and stratified sampling among others. The sampling technique to be used in the audit will depend on the degree of accuracy required in the sampling plan and its eventual inference to the total population of the items being tested such as a review of the accuracy of an inventory maintained as part of a contract.

"A simple random sampling means that each possible sample of a given size in the total population has an equal chance of being selected." (Spurr & Bonini, 1973, p. 132).

"A systematic sample is one in which every *k*th, item e.g. every 10th item is selected in a list representing the total population. The number *k* is called the *sampling interval*. The first number is chosen at random from the first k items. Systematic selection ensures that the sampling will be spaced evenly throughout the population." (Spurr & Bonini, 1973, p. 132).

The sample selection for a systematic sample is determined by dividing the total population by the sample size. This determines the interval or for example every 10th item selected for audit compliance testing.

The sample size is computed by taking into account the degree of accuracy required as part of the sampling plan and its eventual inference to the entire population.

Compliance Test Procedure

A compliance procedure is an action that can be described by a two-part statement. Part one identifies the data population from which the sample will be selected. Part two defines the task to be performed to gather the evidence about the items.

The procedure should state the reason for the sampling. For example, to test the accuracy of the inventory, and to compare the results of the physical inventory to the perpetual inventory records. Further the Compliance Test Procedure should specify the Objectives, Relevant Population, Sample Size, Sample Selection, etc.

Table 1 is an example of a Compliance Test Procedure using systematic statistical sampling. For purposes of the discussion, inventory was chosen as the means to demonstrate the compliance test procedure.

DISCUSSION

Most organizations adopt some type of formal ethics policy stating what is acceptable business behavior. Ethical policies have evolved to include a spectrum from gifts and gratuities to bid rigging and bid rotating. Contract compliance monitoring is as necessary to maintain an open and fair procurement process in a public or private organization, as the review of purchasing staff and supplier conduct. Suppliers may not

TABLE 1
Compliance Test Procedure – Inventory

Scope	To test the accuracy of the physical inventory by comparing it to the perpetual inventory. With a computed risk of 95%, the results of the inventory audits can be equated, with 95% confidence, to the entire physical inventory population.
Objectives	- Verify the physical inventory and compare it to the perpetual quantity on hand. - Verify that the inventory is marked with the correct stock number and the information matches the perpetual inventory record. - Verify that the physical inventory is stored at the location listed in the perpetual inventory record.
Revelant Population	Inventory having a quantity on hand of zero with usage recorded. Inventory with a quantity on hand greater than zero.
Sample Size	- Acceptable Upper Precision Limit (AUPL) 92 TO 95% - Risk and reliability 95% - Estimated rate of occurrence 4% - Sample size 150 items.
Sample Selection	Relevant population/sample size = figure for systematic random sampling. For example, 2550/150=17. Select every 17th item in the relevant population.
Auditing the Sample	Compare the physical count to the quantity on hand in the perpetual records.
Evaluating the Evidence	- Quantitative – compare the sample result to the Acceptable Upper Precision Limits of 92% to 95% accuracy with a Computed Upper Precision Limit of 95%. - Qualitative – Overall evaluation of the sample results related to the entire population.
Final Decision	Statement that the exception proportion meets, exceeds, or fails to meet an intermediate degree of compliance 92% to 95% accuracy.

equate failure to perform on a contract as a breach of the public trust, nor may a purchasing employee deem the lack of contract management as a breach of his fiduciary duty. The results of both are the same: failure to provide the public confidence that procurement is fulfilling its obligation of fiscal responsibility and fairness as it exercises its role of support for the organization's primary mission while serving the public.

As indicated previously, it is important for an organization to validate whether a contract is being used for the purposes intended. Organizations spend extensive time and effort to identify needs and solicit solutions in the form of a bid or a Request for Proposal. A critical part of the process is for the organization to establish and execute a contract that results from a solicitation. Implementing the use of a contract resulting from a solicitation allows the organization to realize the intended benefits whether in the form of cost savings or addressing a need within the organization.

Implementing contract audits allows an organization to determine if the supplier adheres to the terms of the contract as it relates to performance and invoicing. During the course of an audit, the invoicing should be reviewed for accuracy and specifically to verify if the charges are correct in that the invoices match and accurately reflect the billings allowed in accordance with the terms of the contract. Occasionally, contract performance issues may be discovered during an audit. Audits can address performance related issues by bringing management's attention to control weaknesses. Implementing controls to address the weaknesses will reduce the risk of future contract performance issues or overcharges. In some organizations, an audit may primarily need to identify the bottom line effect as a result of control weaknesses in order to gain management's attention and obtain effective, long-term results. Identifying and applying a monetary value to the consequences of control weaknesses usually draws the organization's attention to the bottom-line effect of the control weaknesses.

The use of statistical sampling in auditing is well documented. Systematic sampling has come into widespread use because it is easy to apply and it usually yields good results. At the same time, the reliability of the information is sufficient for almost any purpose (Spurr & Bonini, 1973). As a result and because of the efficiencies and the cost savings it affords, statistical sampling should be incorporated where appropriate into any contract audit procedure.

The goal of statistical sampling is to arrive at a decision regarding a business or its processes. The audit or review of the process is conducted by sampling a portion of its data or production output in an unbiased, statistically valid method so as to infer the outcome of the sampling to the entire population of the business or manufacturing process being tested.

After completion of an audit, it is imperative for the organization to review the findings and develop a remediation plan to address the issues discovered by the audit. This may involve developing an action plan on an individual contract basis or may involve more extensive corrective measures such as creating new policies and procedures in the procurement process. The failure to remediate the problems discovered by the audit review can affect the cost savings and performance deliverables during the remainder of the contract term.

A successful remediation plan must involve the key internal and external stakeholders of the organization including the supplier, user group, audit team, risk management, finance, and procurement. A time line to correct the issues discovered in the audit will serve to keep the progress of the plan on schedule, particularly with the other demands and limited resources of most organizations. The remediation plan should stipulate the progress points or accomplishments that must be completed during certain time intervals and allows for grace periods in the event the plan is behind schedule. After completion and execution of the remediation plan, the organization would be well served to conduct periodic follow-up reviews to ensure the corrective measures established by the remediation plan continue to be implemented. The periodic reviews can be determined based on the term of the contract agreement. If the remediation involves the implementation of new policies and procedures related to the procurement process, the review should occur annually.

NOTES

The views expressed are solely the authors' and do not necessarily represent those of the School District of Philadelphia.

ACKNOWLEDGEMENTS

The authors wish to extend their thanks and gratitude to Ms. Barbara Di Luzio for reviewing and editing of the paper.

REFERENCES

Allen, Michael B., *The Ethics Audit:A Tool Whose Time Has Come,* (Nonprofit World, 1995) Madison, WI: Society for Non Profit Organizations.

Damato, Victoria, Wagner, W. Jack, *Is Your Ethics Policy Effective*, (Purchasing Today, 1997), Tempe, AZ: Institute of Supply Management.

Engel, Robert J., *Sarbanes Oxley Impact on Supply Chain Management*, (Supply and Demand Chain Executive, 2006), Gilbert, AZ.

Fearon, Harold E., Dobler, Donald W., Killen, Kenneth H. *The Purchasing Handbook.* (1993) New York: McGraw-Hill.

Geffken, Carl, (2004, October) Global Cosmetic Industry: *Internal Compliance Audits – A Real Asset*. Available: (WWW).http://www.findarticles.com/p/articles/mi_go2150/is_200410/ai_n7325498.

Institute for Supply Management [ISM] (2001) *C.P.M. STUDY GUIDE*. Tempe, AZ: Author.

Institute for Supply Management [ISM] (2004) *Supply Management Audit for Social Responsibility*. Tempe, AZ: Author.

Spurr, William, A. and Bonini, Charles, P. *Statistical Analysis For Business Decisions* (1973), p. 332. Homewood, IL: R. D. Irwin.

Townsend, R. (2003, April). Internal Auditor: *Strategizing for success: before engaging in contract audit activity, assess your department's capabilities and formulate an effective strategy.* Available: (WWW) http//www.findarticles.com/p/articles/mi_m4153/is_2_60/ai_100075071/print.