Stewardship: Extended enterprises

Current environment: New model for delivering public services

In the wake of the deep austerity facing many public sector organizations around the world, leaders are challenged with increased scrutiny over the public money they collect and spend and expectations to “do more with less.” Public services have traditionally been delivered through hierarchical public sector organizations’ bureaucracies. But these days, that vertically integrated model is giving way to a horizontal approach involving a complex blend of federal, state, and local governments—along with increased outsourcing involving private businesses, third-party contractors, and non-profit institutions. In this new model, the role of the public sector organization has transformed from direct service provider to leader and manager utilizing outsourcing and other forms of agreements to extend capabilities.

These networks are becoming a fixture at many levels of government. Outsourcing is on the rise in Europe, including a number of public school systems that have hired private firms to build and maintain their facilities and infrastructure so educators can focus on education. In New Zealand, the country’s highway infrastructure is designed, built, and repaired by private firms. In the United States, federal service contracting has grown significantly over the last 10 years. Private contractors, for example, currently support the U.S. military with a wide range of ancillary services, freeing up active duty military personnel to focus on the core mission. India is another example where several infrastructure projects are being developed from public-private partnerships (PPPs).

The examples provided above represent a new level of cooperation between the public and private sectors, responsibilities and risks are now shared in a very different manner, which has led to a new business model. Public sector organizations increasingly rely on contract-based relationships, including performance-based contracts, to support their strategies and advance their goals. Unfortunately, a contract does not shift the ultimate responsibilities and cannot guarantee the success of the underlying service levels. Indeed, while accountability for performance under the contract falls on both parties, the role of the public sector in this increasingly outsourced model changes to involve greater oversight.

Given global business conditions, fulfillment and monitoring of contractual obligations by the extended delivery contractors has become more critical and challenging. These responsibilities call upon the parties to contracts to scrupulously meet cost control, service quality, outcomes, and risk management goals. Parties often face increasing pressures, and even temptations, that can subvert intentions and undermine performance and ultimately limit the chances that objectives are achieved.

Accordingly, efforts to verify that the external business relationship perform as expected have taken on greater importance. Those efforts go by various names, such as vendor management, contract management, contract compliance, revenue assurance, program integrity, contract risk and/or compliance programs. To explicitly include risk management, improvement or opportunity management and compliance dimensions, Deloitte uses the term Contract Risk & Compliance (CRC) for such programs.

Despite its importance, CRC is often overlooked by public sector organizations intent on securing favorable contract terms, and by risk managers focused on the insurance, regulatory, security, and legal aspects of contracts. After signing a contract, many executives assume that the specific parties will perform as expected or that relationship management and risk monitoring mechanisms are in place and functioning properly. Some even behave as if contracts transfer risks to another party, when in fact they may generate new risks, further underscoring the need for CRC programs. This complacency has often led to inefficient and ineffective ongoing management of contracts, potentially jeopardizing public interest.

Business relationships depend on trust, but trust is earned over time through dependability, fairness, and sharing of accurate information. Thus, the byword in business may be President Ronald Reagan's saying, "Trust, but verify." In that vein, a contractual relationship can provide the context in which parties build trust as they continue to validate and deploy their contract as an ongoing guide rather than a one-time documentation of intentions.

Why CRC now?

To manage risks, the enterprise should identify the risks to which relationships can leave the organization or its constituents vulnerable. A CRC program helps realize the benefits intended in a relationship, while identifying and managing the ongoing risks. A CRC program is now among the most advantageous uses of an organization's resources because:

1. In a period of economic turmoil, the revenue function is looking to capture all of the revenue due and attain the cost savings attainable in extended relationships.
2. Extended program and service delivery relationships—and thus risks—multiply with increased use of outsourcing, joint ventures, and other methods of employing other entities.
3. Public organizations should work to avoid potential liabilities or additional costs associated with counterparties and their respective activities.
4. CRC programs help determine that the counterparty meets the intended outcomes and objectives of the relationship.
5. Failure in meeting objectives could result in significant reputational damage.

Using CRC to Mitigate Risk

The emergence of the extended-enterprise model in the public sector has introduced potential risks that need to be identified and effectively mitigated. Given that a number of public sector organizations are increasingly reliant upon other parties, strengthening these business partnerships will be critical in effectively completing their mandates. So, how do public sector organizations begin to develop effective links, processes, structures, and dialogue with their external business counterparties? What kind of mechanisms can help address the inherent risks associated with the extended enterprise?

A CRC program provides an effective roadmap to develop a broad understanding of the state of extended relationships—and to gain comfort in relying on information reported by business counterparties. Core CRC activities include the following:

- Identifying the relationships and associated inherent risks
- Clarifying objectives, risks, controls, and benefits connected to extended delivery (business) counterparties
- Understanding compliance (and noncompliance) with contract(s) or agreements
- Reviewing the accountability/funding agreements to assess the effectiveness and efficiency of service, accountability and appropriateness of the spend
- Validating the accuracy and completeness of information reported by extended business counterparties or program delivery agents
- Performing onsite or offsite risk assessments and control reviews of extended business counterparties, and program delivery agents

Examples of CRC activities in the Public Sector:

- Federal or state/provincial funding: improper payment reviews, grant/program review or audits, matching funds programs, joint development construction contracts such as, PPP contracts for infrastructure programs
- City or county/municipality: joint development construction contracts, monitoring controls and risk identification
- Suppliers: supplier quality audits, government pricing reviews, environmental/regulatory compliance, ordinance/law compliance (political contributions)
- Outsourcing support: call service review, service provider reviews, IT controls and security assessments
- Revenue assessments: fee collection review, natural resource royalty inspections, real estate lease inspections, revenue reporting

CRC activities are performed both inside and outside the organization—agencies, broader public sector or private sector organizations. Internally, an organization should evaluate its practice of oversight and contract management, its use of communication protocols, and its internal analysis of business counterparty activities. Externally, a public sector organization should consider its program to assess compliance for contracted or outsourced activities. To get a better idea of a CRC program, here is a brief overview of some key components: people, processes, and methodologies.

People: Ownership and accountability should be built into the roles of employees of both organizations involved in a business partnership. CRC program owners should be aware of the business objectives, the contract, any metrics, and applicable monitoring procedures for the CRC program to be effective. As with many significant initiatives, education is critical for success, both initially to get the program started, and continuously to monitor, reinforce and refine activities. Contractual counterparties should also be encouraged—if not contractually obligated—to educate their key employees on their responsibilities around the obligations and duties associated with the business agreement.

Processes: CRC activities constitute an end-to-end process. Phases of the process include:

- **Identify Relationships.** A careful review of extended business/delivery counterparties and their related contracts can help remind organizations of their commitments and contractual obligations and can lead to opportunities, such as, improving controls and operations and delivery capabilities, along with renewals—or negotiating better contract terms and upgrades.
- **Identify Relationship Objectives.** Effective risk management programs of various types usually begin with the identification and articulation of objectives that forms the basis of the extended business relationship. Clear understanding of the objectives helps focus on the risks/exposures that may inhibit the achievement of those objectives.
- **Assess Risk.** Individual risks lurk in and around extended enterprise relationships, and an organized assessment is required to identify and prioritize them—as some contracted organizations will pose greater risks than others, due to internal factors, such as a weak control environment, or external factors, such as the strategic importance of the relationship.
- **Evaluate compliance both internally and externally.** Either party in a business relationship may contribute to objectives not being efficiently achieved and being "out of compliance" could evidence ineffective practices. Inaccurate reporting, for example, could stem from manual or ad-hoc processes and systems used to comply with the contract on both sides of the business relationship. Either way, noncompliance needs to be addressed or it could jeopardize optimal functioning and decision-making for the whole enterprise.
- **Mitigate Risk.** Activities to mitigate risk—such as strengthening contract terms, communications, policies, ongoing monitoring of compliance and procedures to align with the organization's mandate—can lead to greater trust, security, and controls and efficient achievement of the objectives.

Methodologies: As public sector entities initiate or modify their CRC program, they may want to determine the suitable mix of detective and preventive methodologies.

- **Detective.** Many compliance activities are "detective" in nature, including on-site record validation, control evaluation, and "secret shoppers," to name a few of the activities. Detection, by definition, involves analyzing historical data and activities that have already occurred, amounts previously reported, and actions that have occurred. Frequently, it requires some level of review at the counterparty's facility, and testing of the data and activities.
- **Preventive.** Preventive activities, such as communicating expectations or suggestions for improvements, may be conducted in advance of a review or reporting and are frequently performed "off-site" as they are considered less invasive than detective activities. Preventive activities usually involve identification, contracting, training, monitoring, analysis, and trending. Although preventive controls can also be established within the business counterparty's environment, they are typically included within the organization's own processes.

Although detective activities can be performed apart from the preventive, a broad approach that combines both preventive and detective activities is often recommended for an optimal CRC program.

CRC Program Design

To develop an effective and efficient CRC program, it is important to clarify the overarching goals and to consider the underlying relationships between the organization and its counterparties. It is helpful to consider the following six factors so that the appropriate CRC program and corresponding resources are selected to achieve the desired outcome:

1) **Mandate/objectives** (of the public sector organization, the CRC program, or the business relationship): achievement of mandate, revenue recovery, cost avoidance, controls assurance, operational efficiency, etc.
2) **Complexity and number of contractual relationships:** contract structure and application across organization's functions and/or counterparty companies, performance metrics, audit clauses.

3) **Organizational culture**: the extent to which both the organization and the counterparty is controls-focused; consideration of the counterparty's role in the context of the business relationship.
4) **Counterparty compliance program stakeholder:** legal, operations, internal audit, finance, and other "owners" will each establish slightly different business objectives, which may be accompanied by slightly different attitudes toward compliance.
5) **Relationship between counterparties, future expectations, and past outcomes:** degree of trust; short-and long-term relationship goals
6) **Timing of renewals:** seasonal considerations, contract renewal cycle

Once the objectives have been established and the basic CRC program developed, some consideration should be given to the level of cooperation one might expect from the counterparty, since certain business objectives naturally drive different degrees of collaboration. For instance, if a partner is excessive in its drive for monetary findings, then the counterparty might be resistant or even evade the review—with attempts to delay or interrupt the progress.

On the other hand, if the counterparty expects the inspection to be objective and could potentially result in process improvements or better communication for both parties, then the counterparty may be more open to the compliance effort.

CRC Program Challenges

Although many public sector organizations are aware of the need for effective CRC activities, many are reluctant to initiate or contract for CRC programs because of certain misperceptions around performing on-site compliance activities. Common concerns around initiating CRC activities include apprehension over potentially harming the relationship, the cost of the CRC program, and inadequate contract terms with the business counterparty that would authorize or permit certain CRC activities.

One strategy for overcoming some apprehensions involves clear communication about the necessity and benefits of the program including highlighting that the program will be monitored by a professional who is objective, professional, and diligent. To meet these objectives of a CRC program, many public sector organizations engage an outside party such to help establish and conduct the program. Deploying an objective party to collect information and/or perform the inspection can provide a comfortable distance between the public sector organization and its counterparty.

Conclusion

By deploying a risk-based, CRC program, public sector organizations can reduce excessive costs, identify data-quality problems, unveil operational inefficiencies, and reveal structural weaknesses that could otherwise cause significant reputational damage. In addition, a well-tailored CRC program can help public sector organizations proactively manage the unique risks of the extended enterprise to create opportunities that optimize their contractual and business relationships. The resulting benefits, including increased assurance that the mandate will be met, cost reduction, controls enhancement, compliance, and relationship enhancement, may lead to new ways of viewing compliance efforts.

Designing and deploying a sustained CRC program takes time, involves dedicated resources, and requires a solid understanding of the underlying business objectives. Many leading companies—in both the private and public sector—can testify to the benefits.

An intelligently run CRC program is simply good business. It can demonstrate that business counterparties are exercising proper diligence required to meet joint objectives, and it can foster trust in the extended-enterprise system. Further, it can demonstrate to the taxpaying public that the public sector organization has strong governance, maintains robust internal controls, and makes effective use of public funds.

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