

## **PROCUREMENT PROCEDURES IN THE FUNCTION OF IMPROVING COMPANY BUSINESS CONDUCT**

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*Scientific paper*

### ***Abstract***

The subject matter of this paper are activities related to the implementation of public procurement in companies owned by the Republic of Croatia. The field of public procurement is of great importance both for the economy and for companies, because it has positive effects on the economy, but also contributes to significant savings to clients, i.e. companies. The field of public procurement is the subject of interest of the public. Rational approach to public spending is a priority in EU Member States. Public procurement payers in the European Union are spending significant resources for procurement of goods, works and services. The efficiency of public procurement has become important for Member States. Public procurement is a field of interest in company business conduct. This paper examines the possibilities of improving the efficiency of public procurement in companies. The research is based on data on effectiveness audit of the procurement system in ten companies owned by the Republic of Croatia. The analysis of the value of procurement conducted, efficiency recommendations and the possibility of their influence on improving business conduct have been performed. This paper confirmed the importance of the implementation of procurement procedures and their meaning and impact on the world economy as a whole, and its importance for companies in improving business through activities in the field of implementation of recommendations related to the effectiveness of the procurement system. The analysis method is used to process data on the value of public procurement, and the method of synthesis combines the data and comparison method is used for comparison of companies. The opportunities for improving business by implementing the recommendations are different. The logistics system of the company has the task of ensuring optimal amounts of all material, information and value flows in the transformation process of the company.

Successfully planned, organized and connected all logistics functions are a prerequisite for making decisions on business conduct, which is reflected in the data reported in the financial statements that serve the owners, the public and other users. The auditor's opinion is a confirmation of the value and credibility of financial statements.

**Key words:** audit, public procurement, company, efficiency

## 1. INTRODUCTION

Companies operate in an environment that is constantly changing and evolving. In modern market conditions system management reduces uncertainty. The environment affects companies in a way that changes in the environment affect the company, but accompanies also affect changes. Knowing the situation in the environment became a necessity. The functioning of the elements of the system takes place by converting inputs (machinery, raw materials, financial resources, energy, human resources, etc.) into outputs (products, services, financial performance, etc.). As part of business process management companies establish goals, which also relate to procurement procedures. Supply should provide the necessary inputs at the lowest procurement cost. Effective procurement is one of the prerequisites for achieving set business objectives. The competence of the State Audit Office is also to conduct efficiency audits.

The term audit entails examination of documents, papers, statements, internal control and internal audit systems, accounting and financial procedures and other records in order to determine whether financial statements represent the factual financial position and results of financial activities in accordance with accepted accounting principles and accounting standards. The audit is also a procedure of examining financial transactions in terms of legal use of funds. Audit also includes an assessment of the efficiency and effectiveness of activities and an assessment of the effectiveness of achieving business goals or objectives of individual financial transactions, programs and projects (State Audit Office Act, Official Gazette 80/11, Article 7). The tasks of the audit are financial activities, as well as activities aimed at determining the effectiveness, cost-effectiveness and efficiency. In performance audit the auditor makes recommendations for improvements, which should help to strengthen accountability in the public sector, improve the activities related to the control and planning which will contribute to an efficient, effective and cost-effective use of public sector resources in achieving the desired goals. An audit of all functions in a company is based on the evidence, the compliance of all financial statements and determined criteria.

The logistics are activities used for planning, executing, implementing and controlling the space-time transformation of the goods and related transformation. Procurement procedures provide input and influence the course of the business process, therefore the audit may affect the improvement in these activities via recommendations. The success of management is confirmed through all business functions, both through the process of planning, organizing, managing, and the

function of logistics. This paper examines business conduct of companies and analyses the possibilities of improving the efficiency of public procurement. Through activities in the field of public procurement the use of resources of the public sector in achieving greater value for money is improved.

## **2. IMPORTANCE OF PUBLIC PROCUREMENT**

### **2.1. Importance of Procurement in Economy**

The importance of procurement in the economy is reflected in the fact that within the European Union priorities which complement each other stand out, and they refer to the "smart growth, development of economy based on knowledge and innovation, sustainable growth by promoting an economy that effectively exploit resources, which is greener and more competitive and inclusive growth with high employment rate, which brings social and territorial cohesion" (European Commission, 2010, p. 6). The Strategy states that public procurement policies must ensure the most efficient use of public funds and that procurement markets must be kept open throughout the European Union.

The economic situation requires rational approach to public spending, thus the efficiency of public procurement has become a priority for all Member States. The importance of this sector stems from the fact that 20.0 % of GDP at the European Union level is consumed by the institutions and public authorities, as well as other public entities, through procedures that involve the purchase of products, services and works (Anti-fraud measures in public procurement in the EU single market, legal, institutional and technical solutions, p. 1).

Logistics involves a series of activities carried out with an aim of efficient movement of necessary inputs. There are many definitions of logistics. One of them is "Logistics entails the totality of activities in setting up, securing and improving the availability of all people and resources, which are assumptions, assistance or insurance for flows within a single system" (Segetlija & Lamza-Maronić, 2000, p. 83, taken from: Entwurf DIN 69906, according to: Rupper, Hrsg. 1991, p. 7). From the above, we can see the importance of ensuring delivery of the right product, at the right time, at the right place, and in the right form, and at minimal cost. Logistics can also be understood as a system of flow of goods, materials and energy that connects procurement markets to the places of production and consumption. The above can be applied to business conducts of companies owned by the Republic of Croatia, which are investigated in this paper. It is necessary to carry out the procurement of goods, works and services required for the business, but at minimum cost. Therefore, the implementation of procurement procedures has a significant role. The paper analyses the value of procurements conducted in companies.

Within the frame of economic system companies are subsystems: production, sales, research and development, procurement, finance, human resources, information and others. In this respect, the logistics for managing business processes stands out, within containing logistics objectives for individual business functions. Logistics procurement objectives are: the main goal highlighted is to provide the necessary raw

materials, components and semi-finished products for production at the lowest cost, while individual targets include delivery of materials and parts required in accordance with contracts, delivery of materials or parts directly from suppliers and from own warehouse at the lowest costs of preparation, minimizing inventory and parts required for the production, arranging short delivery times with suppliers and more. Logistics can influence the achievement of rationalization, and can ensure competitive advantage of the company. For companies involved in trade there is no production, and consequently there is no logistics of production, but flows of information are very significant. Audit is also affected by the application of information technology in business conducts of companies. Using information technology increases the number of trade relations, which affects the process of audit since the auditor has to examine increased number of transactions.

International Organization of Supreme Audit Institutions has issued standards. The ISSAI 300 standard (International Standards of Supreme Audit Institutions) provides Fundamental Principles of Performance Auditing. The definition of performance audits is: "As carried out by SAIs, performance auditing is an independent, objective and reliable examination of whether government undertakings, systems, operations, programs, activities or organizations are operating in accordance with the principles of economy, efficiency and effectiveness and whether there is room for improvement" (INTOSAI, ISSAI 300, item 9, p. 2). From the above we can see that audit subject depends on set audit goal, i.e. parts of a certain whole can be audited, depending on the public interest.

This paper examines the field of procurement of goods, works and services using the example of audited companies and issued recommendations within the frame of public procurement with an aim of reducing costs and improving business conducts.

## **2.2. Public Procurement in Companies**

Public procurement is regulated by the Public Procurement Act. From a total of ten companies, five companies were obliged to apply the said Act, and five companies were not obliged to apply the aforementioned Act.

The total value of public procurement for ten companies, from 2011 to 2013 amounted to HRK 17,453,129,837.00 (Report on performed efficiency audit of public procurement systems in companies owned by the Republic of Croatia, 2014, p. 2). Table 1 provides an overview of companies and procurement values from 2011 to 2013. From these data we can see that the value of public procurement is significant and, therefore, the field of procurement deserves great importance. Two companies have a share of 82.62 % in the total value of procurement, while remaining eight companies only have a share of 17.38 % in overall procurement value.

Five companies were obliged to apply the aforementioned Act: Rijeka-Zagreb Highway, company for motorway construction and management JSC, HEP Plin Ltd.; Hrvatska Elektroprivreda (HEP) JSC, Croatian Motorways Ltd. and Jadrolinija. The total value of procurement by companies that are subject to the Act is HRK 16,367,345,130.00 or 93.78 % of the total value of public procurement of audited companies. Of five companies obliged to apply the Act, two companies have a share of 82.62 %, whereas three companies have shares that are individually less than

10.0%. The remaining five companies that are not obliged to apply the Act have only a share of 6.22 % in overall procurement, and only one company has a significant share, while the other four companies have an individual share amounting to less than 1.00 %.

**Table 1.** The value of public procurement of companies from 2011 to 2013 in HRK

Number	Company name	Public procurement value	Share in %
1.	Adriatic Croatia International Club JSC	94,403,952.00	0.54
2.	Medena Apartments JSC	12,532,031.00	0.07
3.	Rijeka-Zagreb Highway, company for motorway construction and management, JSC	358,558,418.00	2.05
4.	HEP-Plin Ltd.	42,664,202.00	0.24
5.	Hrvatska Elektroprivreda (HEP) JSC	9,143,356,742.00	52.39
6.	Croatian Motorways Ltd.	5,276,353,161.00	30.23
7.	Jadranski naftovod JSC	824,584,544.00	4.72
8.	Jadrolinija	1,546,412,607.00	8.87
9.	Kaštela Greenhouses JSC	11,276,473.00	0.07
10.	Port of Rijeka JSC	142,987,707.00	0.82
Total		17,453,129,837.00	100

Source: Table drafted by the authors according to the Report on performed efficiency audit of public procurement systems in companies owned by the Republic of Croatia, 2014, p. 3.

In order to make conclusions on the effectiveness of the procurement system in the observed companies, we defined sub-issues relating to the organization of procurement planning, prescribed ways of managing public procurement procedures and the establishment of a system of controls that monitor the enforcement and application of the agreement and whether the procured goods, works and services ensured the realization of planed goals, i.e. whether the efficiency of the company has been improved.

After the audit recommendations were given to companies in three areas. In the area of procurement planning a recommendation was given to all companies, as is the case in the area of public procurement procedures management, while in the area of

monitoring the enforcement and implementation of the agreements the recommendation was given to eight companies.

### **2.3. Analysis of Possibilities for Improving Public Procurement Efficiency**

Through activities in the field of public procurement it is possible to improve business conduct and thus affect the achievement of the objectives of the organization. "In addition to the executive tasks in the field of procurement, storage, internal transport, handling of raw materials, semi-finished goods, etc., the logistics entails the use of decision-making model regarding the performance of these activities" (Segetlija & Lamza-Maronić, 2000, p. 88). From the aforementioned, we conclude that making decisions regarding the performance of activities, should also be paid attention to since the goal is not just to perform the procurement, it involves meeting other objectives (with minimum financial resources, a certain quality, etc.), which ultimately affects the whole organization.

One of frequent questions is inventory. Therefore, models of inventory management deal with questions how often clients should order additional raw materials and how to order them and how many products should be manufactured in a given period in order to ensure that stocks of finished goods are sufficient. „Effective management is much more than just a question of working with numbers. A successful manager relies on common sense and intuition; on sensibility for people who cannot be quantified; and the creativity that goes beyond the numbers" (Collins & Devanna, 2002, p. 95). This confirms that managing the inventory necessary for business requires computational justification, but includes elements that cannot be quantified. Effective inventory management can result in a significant increase in profits with companies that have large amounts of capital tied in the inventory or those that lose sales because their stocks are constantly empty.

Stocks is an area covered by audits, by checking contracts, payments, account balances and more. The auditor in his work uses a variety of methods, including the method of samples. „The starting point in assessing the accuracy and fairness of the financial statements is sufficient evidence on which the auditor can form an opinion and a make a conclusion on the audited financial statements. In order for an auditor to in a very short time gain insight into the company's business and to check the validity and accuracy of individual transactions and events in a certain company, method of samples can be of great help "(Crnković et al., 2010, p. 134). Method of samples is gaining importance when checking the condition of individual accounts, and is often used to draw conclusions related to stocks. For companies that are included in this paper, recommendations are also made regarding stocks. After examining the individual audit on the effectiveness of performed public procurement, six companies had registered stocks. It was noted that the majority of companies had not established optimal inventory and procurement is performed on the basis of empirical methods. Written procedures on stock goods policies had not been established. For a company which had the largest stocks of all companies included in this study, the audit process found that the accounting policies of the inventories were used for determining goods or asset that constitute stocks (spare parts, supplies, small inventory in stock and in use) and that they had been evaluated according to their cost

or net market value, whichever is lower (Report on Performed Procurement Audit in Jadranski naftovod JSC Company., 2014, p. 5). Cost includes expenditures incurred by purchasing and bringing the inventories to the current situation and to their current location. Expenses are determined by using the weighted average method.

Within the audit of procurement cycle it is characteristic that it is the implementation of procedures that are not demanding, but it is assumed that misstatement are more likely than in other accounts. Business events in procurement procedure are procurement of goods and services for money or with deferred payment, payment of obligations, and return of goods to the supplier. These business events affect the accounts payables to suppliers, stocks, cost of goods sold, different accounts of assets and expenditures, monetary funds and more. The course of procurement cycle is followed by different documents: procurement orders, purchase orders, receiving reports, incoming invoices, payment authorizations, statements and more.

"The main objectives of the procurement cycle are acquisition of goods and services at the lowest cost consistent with the required quality and the effective use of available money for paying goods and services" (Messier, 1998, p. 443).

Audit procedures are used for validating business events, completeness, timeliness, approval, the acquisition price, record in the prescribed accounts, computational accuracy, and business activities related to payment (approval, recording period, amount, transfer to general ledger, etc.). Options for improving efficiency are observed in the three areas described below.

### *2.3.1. Public Procurement Planning*

In the field of public procurement planning irregularities are frequent, which was established for all companies and recommendations had been issued in order to increase efficiency. The meaning of planning in the business process is of extreme importance.

In the audit process analytical methods are used to test financial information. Analytical methods referred include "comparison of financial information for the current year with comparable information for the previous period after taking into account known changes; comparison of financial information for the current year with budgets, projections and forecasts; the relationships between elements of financial information for the current period; comparison of the principal's financial information with the information for the overall activity; and the relationship between financial and non-financial information" (Messier, 1998, p. 166).

Analytical methods have been applied in the observed companies, comparing the planned procurement value with realized values. Often applied comparison is comparison of values from one year compared to the values of other years. In this way we come to conclusions regarding unusual items or items that have been planned, but have not been performed or have been performed, but have not been planned. The importance of procurement plan stands out because its drafting is prescribed by legal provisions.

Irregularities in the field of procurement planning are common, and most common irregularities are:

- Procedures which would determine obligations of users and organizational units in procurement planning have not been adopted
- There is no written evidence of requirements of organizational units and conducted market research, which serves as a basis for making procurement plan
- Procurement plans have not been adopted or have not been adopted before the beginning of the appropriate financial year, and have not been published on the website
- Certain planned procurement procedures have not been undertaken
- Lack of written explanations regarding deviations from planned achievements
- In some procurement cases, particularly urgent ones, there is no written explanation justifying the procurement
- Annual financial plans do not contain elaborately explained positions and connection with positions in planned procurements
- Procurement plans do not include information on the procurement and the estimated value of procurement for items whose estimated procurement value is equal to or greater than HRK 20,000.00 and less than HRK 70,000.00
- Internal acts which would regulate procurement of goods and services of estimated value up to HRK 200,000.00, i.e. HRK 500,000.00 for procurement of works have not been adopted.

Based on the established irregularities, in order to improve operations, we recommend adopting written procedures for planned procurement, drafting a procurement plan with all the required elements, foresee dynamics of procurement and procurement period, assessing the feasibility of planned procurements, preparing written reasons for deviations from planned achievements, i.e. paying more attention to planning etc. From all these irregularities and given recommendations we can confirm the importance and impact of planning on overall business conduct.

### *2.3.2. Public Procurement Procedures Management*

Irregularities in management of public procurement procedures are common, and most common irregularities are:

- Companies have no internal regulations on procurement procedures management
- Ordinances on application, use and maintenance of purchased goods and equipment, and performance of services have not been drafted
- Before implementation of procurement procedures an analysis of the most appropriate and most convenient procurement method (selection procedures) has not been performed
- For some of the works volume has not been determined, and for certain goods no fixed quantity has been determined
- Omissions in offer analysis, since the offer analysis has not been carried out in accordance with tender documentation
- Companies have investigated market prices, but failed to identify methods of market research and analysis according to a particular object of procurement
- Some companies have not investigated market prices, but have been procuring goods and services from the same suppliers



- Companies – obliged to apply Public Procurement Act have entered into a framework agreements upon completing the negotiation procedures without prior publication, and were obliged to conduct open public procurement procedures
- Companies have procured goods directly from suppliers, without applying the prescribed procurement procedures
- Agreements on procurement of goods, works or service had no provisions regarding penalties for failure to fulfil obligations by the contracted period
- Deadlines for performing the works, i.e. provide services, have not been realistically established and agreement amendments had to be drafted for extending deadlines
- Some companies failed to determine by how much working days contracted construction period had been exceeded and failed to calculate and collect contracted fines
- In some cases different prices had been contracted for the same type of work, not bank guarantees have been given for good performance, and agreements have not been concluded in accordance with offers
- Registers of procurement agreements and framework agreement have not been established
- Deficiencies and omissions have been noted in public procurement procedures and procedures not in accordance with the provisions of the Public Procurement Act
- Companies failed to paid attention to procurement risk assessment and in some cases companies have paid default interest for untimely introduction into business
- Employees who perform procurement tasks have not received adequate training
- Some companies have not established optimal inventory and failed to draft a strategy on inventory management.

Based on the established irregularities, recommendation were issued with an aim of improving public procurement procedures management and some of those recommendations are listed in this paper. The following was recommended: adoption of written procedures to consolidate the manner of management and accountability in the implementation of procurement procedures; to determine which procurement method is the most favourable for the company in order to achieve the best price and the lowest cost; to monitor prices of goods, works and services on the market, and to determine via the internal act the method of analysis of market prices according to the particular procurement case; to establish equivalent work and implement a unified public procurement; to allow the participation of a large number of bidders in the procurement procedures; when viewing the price of items of bill of costs and choice of an offer, to take into account that equal prices are contracted for equal works; to effectively manage procurement risk; to analyse procurement costs according to type and value for the implementation of the appropriate procurement process and the realization of potential savings; regular measurement of value achieved for the money spent; to consider the possibility of cooperation with companies from neighbouring countries that deal with similar work for the application of best practices in procurement procedures; to determine the optimal inventory and to adopt a strategy of inventory management; to occasionally check whether the goods received are of the same quality as the sample on the basis of which the supplier has been chosen and others. Recommendations on improving public procurement procedures management affect all business functions and all resources in a company (material and human).

### 2.3.3. *Monitoring and Enforcing Agreements*

In the area of monitoring and enforcing agreements the following has been determined:

- Procurement control that ensures the legality and regularity of procurement procedures has not been established
- Systematic monitoring and comparison of suppliers during certain period of time, i.e. price of goods, works and services being procured and regularity of agreement execution has not been established
- Systematic monitoring and analysis of total funds spent for procurement in order to improve procurement procedures, i.e. for determining contracting strategy, has not been established
- Services more expensive than contracted have been executed and works that had not been contracted had been executed
- Received goods had not been analysed according to the provisions of the agreement, and bills of costs have not been drafted according to prices of individual services, items or parts procured
- Companies have no records for monitoring execution of individual agreements on public procurement of services,
- Companies have no analysis of utilization of existing vehicles and a feasibility analysis regarding renting personal and commercial vehicles
- In some companies internal audit is not established, while in others it failed to conduct a systematic monitoring of legality and regularity of procurement procedures, but performed occasional monitoring pursuant to individual management requests
- Internal Audit Service failed to perform public procurement procedures audit
- Companies failed to timely submit the notification on agreements concluded for publication in electronic public procurement advertiser.

Based on the established irregularities, recommendation were issued with an aim of improving public procurement procedures management and some of those recommendations are listed in this paper. The following was recommended: to establish records for monitoring execution of individual agreements on public procurement of services; to compile an overview of most common irregularities, problems, perceived failures and errors with suggestions for their elimination and reduction according to individual procurement item; to establish a mechanism of evaluating conducted procurements and inform senior management on the results; to determine the risks in performing public procurement procedures according to procurement items; to monitor and analyse costs by type, value and applied method of procurement to improve procurement procedures; to conduct utilization analysis of utilization of existing vehicles and a feasibility analysis regarding renting personal and commercial vehicles; to establish internal audit and encompass within it public procurement procedures etc. It is not enough just to plan and execute procurement. It is also necessary to pay attention to monitoring the implementation of what has been contracted. That notion is confirmed by irregularities and recommendations made in the area of monitoring and enforcing agreements.

### 3. CONCLUSION

Public procurement efficiency is an important question of all EU Member States, because of the need for a rational approach to public spending. Within the frame of business conduct of companies covered by this paper, the importance of public procurement has been confirmed and the importance of said field in business conduct of companies. This paper examines the possibilities for improving public procurement effectiveness in companies. Improving business conduct of companies is needed for ensuring better business results, but it is also public interest. Through the implementation of recommendations in the field of public procurement it is expected to achieve higher levels of public accountability for the economic and rational management of resources, but also to ensure significant savings. It is necessary to achieve greater transparency in procurement procedures. Changes in the environment affect the business environment, and public procurement procedures allow participation in the proceedings in the European Union. In all ten companies public procurement system was not fully effective. Business conduct improvement is possible and necessary, as confirmed by numerous recommendations. Monitoring the implementation of recommendations is an integral part of the audit procedure. Further audit procedures shall determine which recommendations companies acted on and how the implementation of recommendation has affected efficiency in the field of public procurement.

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