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White Paper

Contract Performance Management: The Need to Bridge Contracts and Business Operations

written by

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Atif Rafiq has been Covigna's CEO since its inception and drives the company's market vision for enterprise contract management. Mr. Rafiq has negotiated, managed, and evaluated more than 1,000 business contracts in his career and led the contract management initiative within a Fortune *50 organization. His domain expertise includes contract design, processes, analysis, and compliance. Mr. Rafiq has held managerial roles at a number of public Internet and software companies in a business development capacity. Previously, he worked at Goldman Sachs where he advised numerous* Fortune *500 executives on key financial management issues across the software, manufacturing, retail, distribution, high-tech, and other industries.*

More than a legal necessity, contracts have a significant impact on many business performance metrics. Yet a large chasm exists between the filing cabinets which store paper-contracts and the operational activities which drive top- and bottom-line performance of any business. Accordingly, there is a burgeoning need for contract management systems which fill this void.

Introduction

It is estimated that a typical *Fortune* 1000 company has somewhere between 20,000 to 40,000 active contracts in place. In the vast majority of cases, the processing (creation, storage, dissemination, execution, etc.) of the contract is completely manual, and the only authoritative copy of the contract is a paper-based version stored in a filing cabinet. In the best cases, an enterprise may leverage existing tools and applications to fill critical holes. Some use document management systems to serve as a repository for text contracts, others use spreadsheets to store key contract terms, or calendaring systems to program key date events. Unfortunately, these approaches lead to a host of fundamental limitations – they do not support the needs of constituents across the enterprise, and cannot interact with other enterprise systems. For these reasons, enterprise contract management (ECM) systems are receiving increased attention. The primary value propositions for ECM are the process efficiencies stemming from automation, and the increased control, visibility, and standardization that follow from centralized, shared processes. These remain compelling value propositions today, and a large number of Global 2000 organizations are beginning to adopt best practices in enterprise contract management. A recent analyst report predicts that 60 percent of *Fortune* 500 companies will adopt ECM within three years time.

> *"Since our contract administration was paper-based, our financial and line-of-business executives did not have easy access to contract information – resulting in a scramble when contractual issues arose. We even had difficulties locating a contract quickly, let alone having good oversight on the terms that we had agreed to. As a CFO, this was an unacceptable state of affairs, which made the deployment of an enterprise contract administration system a top priority for my business."*
>
> **– Dick Borsboom, CFO, Bell Microproducts Inc.**

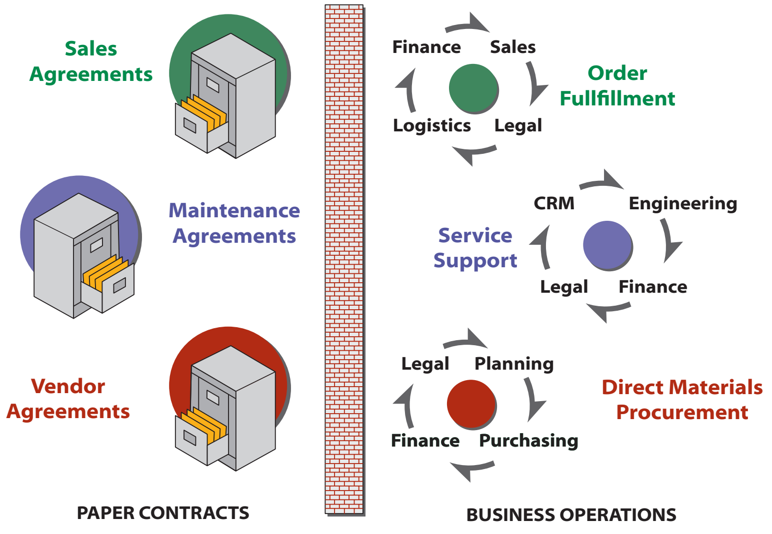

figure 1 *Contracts and business operations are disconnected.*

CASE STUDY 1: THE CFO PERSPECTIVE

Bell Microproducts is a $2 billion component distributor for electronic equipment manufacturers, offering customers a comprehensive product line card. The products that it distributes include off-the-shelf active and passive devices (e.g., microprocessors, microcontrollers, memory chips, capacitors, resistors, inductors, etc.) and other specialty/custom products (e.g., flat-panel displays, storage systems, etc.). The company has several hundred vendor agreements in place, each one vigorously negotiated. The key contract terms relate to pricing and payment, such as list prices, volume discounts, payment periods, penalties, early payment incentives, and price protection clauses.

To bring better visibility of contract terms to front-line managers, Bell Micro's CFO Dick Borsboom is championing the implementation of a state-of-the-art contract administration system for its vendor contracts. However, even after a centralized contract repository is implemented, he believes that significant issues related to financial performance management of contracts will remain unaddressed. For example, inflexible transaction systems will not be able to aggregate purchase orders and apply the proper discount pricing terms automatically. He summarizes this issue for his company as follows:

> *"In the Distribution business, four key operating metrics – return on assets, cashflow, inventory turns, and gross margin – are directly impacted by contractual performance. I instruct my front-line managers to pay close attention to all terms related to pricing, payment, inventory liability, price protection, stock rotation, and termination. Managing performance against these negotiated terms in real-time is crucial to ensure the ongoing financial health of our company."*

The last decade has seen a major shift in the nature of contracts and contracting practices. Historically, contracts have been seen as purely legal necessities to protect against worst-case contingency scenarios. In today's world they are, in addition, tools or roadmaps for the ongoing optimization of business fundamentals. As an example, the structure of negotiated product/service sales contracts determines the schedule for revenue recognition. Performance against the negotiated terms and conditions can have a direct impact on revenue growth, cost of goods/services, risk/liability allocation, and profitability. However, in most enterprises, there still remains a large disconnect between the word of the contract and the systems, people, and processes that support business operations, making it extremely challenging to exert control over the potential impact of contracts. Solving this problem is an emerging priority for the enterprise and, in fact, a large percentage of an estimated $20 billion ECM market is pegged toward helping enterprises tackle this problem. Contract management is one of the few remaining bastions for creating massive value for the enterprise via business automation.

Contract Performance Management: A Critical Next Generation Capability

Given the constantly changing nature of business relationships (renegotiated contracts, new channel/supply-chain partners, demand volatility, new product introductions, etc.), the question arises: Are transactional systems like ERP, order management, accounts payable, etc. enabled to execute the terms of contracts accurately and consistently? More importantly do financial executives have real-time visibility into business performance? Are they able to identify the trends and causality related to poor performance against contractual terms – and put in place the controls in order to maximize profitability? In the vast majority of cases, the answer is negative. Contractual innovation far exceeds the operational capability of enterprise systems to execute contracts accurately and track performance against them.

It is amply clear that the need of the hour is a centralized system for contract management that not only has the capability to administer, encode, and disseminate complex contractual info-rmation in a flexible format, but also is able to

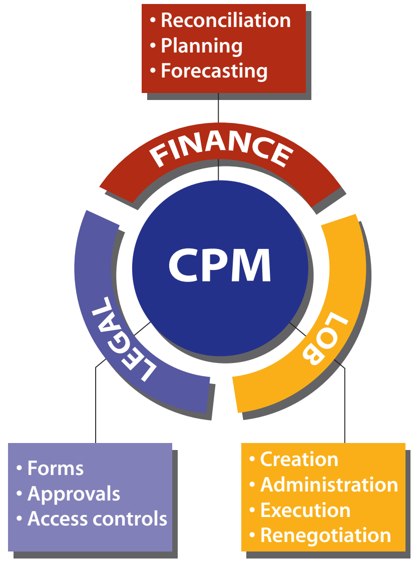

figure 2 *Anatomy of a CPM System*

reconcile performance against contract terms. The solution needs to generate alerts, reports, and transaction logs to identify suboptimal decisions, enforce contractual compliance, and eventually improve the quality of contract terms via renegotiation decision support. For the purposes of this paper, these capabilities have been bundled under the term contract performance management (CPM).

Examples of CPM

Example 1: Purchase Price Compliance

Large enterprises have teams of purchasing managers who painstakingly negotiate favorable pricing with vendors and suppliers. Yet many enterprises remain unable to leverage these arrangements because their payment and invoicing systems were not built to reflect complex contract terms. This results in unnecessary overexpenditure and cost leakage.

Example 2: Inventory Liability Tracking

Supply chain participants (both buyers and sellers) have difficulty understanding how much risk they bear when interacting with partners on key operational activities, such as purchasing and forecasting. Contracts set forth the rules of engagement under which the risk of inventory liability arises. To avoid costly surprises, it is critical to gain visibility over this risk proactively.

CASE STUDY 2:
THE LINE OF BUSINESS PERSPECTIVE

KLA-Tencor (K-T) is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. With over $2 billion in 2001 revenues, K-T has substantial spend through its supply chain. Vice President and Chief Procurement Officer Scott Paull has launched a series of initiatives to strengthen the firm's supply chain capabilities and bring substantial bottom-line benefits to both K-T and its suppliers.

Paull regards contract management as an important element of this program and is championing the implementation of a Web-based contract administration system designed to bring better standardization and visibility to relevant contractual terms and conditions firmwide. By automating template distribution, approval workflow, renewal management and contract renegotiation at K-T, Paull feels that K-T will be better able to implement advanced solutions with its supply base.

> *"Contract performance management is a critical piece of our vision of supply chain excellence. By building a centralized digital repository, we gain the opportunity to capture the best of K-T's worldwide thinking on supply chain management, to communicate more clearly with our suppliers, and to better control both the negotiation and approval of our contracts. Getting to that point is my immediate priority."*

By implementing a CPM system that brings together the contract repository and key operational systems, companies like Bell Micro and KLA-Tencor can better leverage the terms of their negotiated relationships, enabling tens of millions of dollars in ROI.

Example 3: Service Profitability Tracking
Services are a growing aspect of many businesses, yet most find it difficult to understand the profitability of their services arrangements. Service contract specify key entitlements, but without monitoring how these services are being consumed, it is not impossible to know whether these arrangements are favorably structured.

Example 4: Advanced Pricing Management
An enterprise with a large direct sales force constantly enters into complex contracts, which typically vary from account to account. These contracts may feature negotiated pricing terms, such as volume discounts, rebates, product mix incentives, and caps. Transaction systems are not able to manage such advanced pricing terms, which are a consistent feature of sales contracts, making it challenging to enforce negotiated terms.

The Six Essential Capabilities of CPM Systems

Clearly, CPM systems need to build on top of contract repositories and are cross-functional and cross-application in their scope. The following capabilities should be seen as essential in evaluating any potential CPM solution for the enterprise:

1. It fully leverages the data captured within an enterprise contract repository.
2. It enables proactive enterprise involvement in contractual reconciliation by generating exceptions and providing management controls to line-of-business executives.
3. It delivers contract performance information in the form of actionable alerts and reports – with full transaction, approval, and validation support.
4. It supports collaborative processes to bring finance executives into the loop at the appropriate juncture.
5. It maintains rich performance histories to support scorecards and contract renegotiation decision support.
6. It utilizes the latest integration and Web technologies (Java/J2EE, XML, .NET, and LDAP) in order to deliver global, on-demand information access.

Who Should Care About CPM and Why?

CPM is about making the rules-of-engagement encoded in contractual relationships actionable for all relevant constituents in the enterprise. The pain of suboptimal contract performance management is felt both by the CFO and line-of-business executives. The finance organization needs early visibility into contractual upside and/or risks for proper financial planning (chargebacks, claims, reserves, etc). Line-of-business requires visibility into contract performance in order to manage business relationships in a proactive manner. Furthermore, these solutions need to feed performance information back into contract creation and renegotiation, allowing contract and legal professionals to improve the structure of relationships. Ultimately, the winning approach to solve such broad-based contract management problems will be one that supports a closed-loop process to deliver business value to multiple stakeholders within the enterprise. ■