Contract Management Is More out of Control Than You Think

by Kirk Krappé and Gopi Kallayil

Background. As businesses have grown more complex, developing increasing numbers of complex commitments and obligations to customers, partners, and suppliers, the use of contracts has grown substantially. Yet, Global 2000 companies continue to rely on cumbersome, and time-consuming manual processes to manage their contracts. Nextance benchmarked the contract management process in large enterprises to determine where companies stand in terms of their contract management today.

Methods

We interviewed 100+ companies on their contract management processes in four key areas: contract creation, visibility and access, managing and tracking contract commitments, and managing contract risk. Companies came from a wide range of industries and were headquartered in the United States and Europe.

Results and Conclusions

Overall, companies do not come close to achieving best practices in the areas examined in our survey.

- Eighty-one percent of the companies surveyed said that simply finding contracts was a concern. Additionally, 54 percent of the companies found it difficult to access specific terms and clauses without looking through contracts. More than half the companies said they were unable to analyze their contracts by vendor, customer, product, or service line in order to benefit from full negotiating leverage or optimize contract performance from a vendor or customer.

- Contracts define the business relationship and transactions among parties, so managing a contract through its lifetime is critical. Managing contractual commitments, however, was keeping contract professionals awake at night at 75 percent of the companies surveyed.

- The purpose of a contract is to create a vehicle for transferring value in the form of goods and services among organizations. Yet, 40 percent of the companies surveyed felt that they could achieve large savings in their procurement contracts by managing contracts better, and 31 percent felt they could achieve large incremental revenue opportunities by managing sales contracts better.

- The recent focus on corporate governance has heightened awareness of contractual risk. Indeed 75 percent of the companies listed contractual risk as a major area of concern. Nonetheless, few companies adequately track risks: 61 percent of the companies had no idea of the interdependencies among their contracts; 66 percent either did not or rarely tracked side letters; and 60 percent did not track their contingent liabilities.

- We were also alarmed to discover that more than 50 percent of the companies had no reliable process to alert the correct people to respond to the triggered risk, and 26 percent of the companies were dissatisfied with risk disclosure in their financial reporting.

Businesses are increasingly relying on contracts. Over the last 50 years, many of the world's largest firms have advanced from being simple manufacturers of hard goods or providers of basic services to sophisticated vendors using advanced business models that incorporate large numbers of complex relationships across extended enterprises, supply chains, and demand chains. As a result, customers, partners, suppliers, and distributors have increasing commitments and contractual obligations to actively manage in order to collect on negotiated revenue commitments, realize agreed-upon pricing, conform to contract terms, and minimize risk.

Factors further adding to the proliferation of contracts include

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increased outsourcing and federal regulations. According to the National Association of Purchasing Managers, the average Fortune 1000 company now uses between 20,000 and 40,000 vendors, up 20 percent in the five years between 1996 and 2001. As companies strive to create only that which is core to the business and to outsource everything else, firms will have to efficiently manage contracts with increasing numbers of partners, clients, distributors, products, and suppliers.

Federal regulations increase the need for contracts as well. For example, federally mandated Medicaid drug rebates created substantial contractual complexity in the healthcare industry. Subsequent to intervention, the use of contracts governing purchases increased from 15 percent to 80 percent.

As a result, according to the National Association of Purchasing Managers, today, 78 percent of purchases are contracted, while only 22 percent are spot purchases.

Through working with Global 2000 customers, however, Nextance has observed that despite increased use of contracts, businesses have not commensurately improved their ability to manage contracts or the process. Organizations continue to rely on cumbersome and time-consuming manual processes, fraught with human error. According to The META Group, more than 90 percent of organizations rely primarily on manual processes to manage enterprise contracts.

Although there is some anecdotal evidence, no research has been conducted that documents the state of the contract management process within Global 2000 companies. Nextance created and designed a study to determine how well large organizations are able to manage their contracts today and to compare actual practices with best practices so that a scoring system could be applied. We surveyed companies covering the four areas of the contract management process: visibility and access, contract creation, obligation and commitment management, and contract risk management. For a description of the survey methodology, see Appendix A (p. 8).

The following article compares how survey respondents measured up to best practices. The conclusions and results are somewhat startling, showing that most companies struggle with the process and are clearly a long way from best practices.

Visibility and Access

An organization's visibility and access capabilities are defined by how efficiently it can find contracts, access specific information within contracts, and analyze across contracts by customer, vendor, or product.

Best Practices

Best practices in the visibility and access area include the following:

- Contracts can be accessed quickly and easily. The organization uses a repository to store all contracts electronically so contracts are never lost and users from any location can access any contract.

- The company maintains only one version of the contract.

- Terms and clauses within contracts are quickly and easily accessible.

- Electronic storage combined with analysis capabilities allow the organization to search and analyze all contracts across customers, vendors, or products.

Results

We were surprised to find that 81 percent of the companies surveyed reported that simply finding all their contracts when they needed them was an area of concern. Seventy-one percent of the companies thought some percentage of their contracts may be lost, and they would need to go to the other party to retrieve a copy of their contract. Even more startling, one-fifth of the companies we spoke to said that 10 percent or more of their contracts may not be locatable at all.

One of the key reasons for these problems is that companies store their contracts in paper format; 49 percent of companies surveyed said that they stored less than 50 percent of the final copies of their contracts electronically. This leads to a host of problems including an inability to access the right version, find contracts quickly, find specific terms within contracts, and analyze contracts across customer, vendor, or product line.

Storing paper copies of contracts in multiple locations makes it difficult to update all versions of the contract correctly. Our survey indicated that 33 percent of companies have contracts stored in 10+ locations.

Organizations are unable to find their contracts quickly. Close to 30 percent of companies said that half of their contracts will take more than a day to access.

The difficulties with locating information do not stop after organizations find their contracts. Finding specific terms and clauses in the contract is equally as difficult. Fifty-four percent of the companies surveyed have difficulty accessing specific terms.

Often, at large companies, different divisions operate independently. As a result, companies do not know all the contracts they have with a particular vendor or customer or for a particular product. More than half the companies surveyed said they had no capability to analyze their contracts by vendor, customer, product, or service line; which implies that they are not getting full negotiating leverage, or are unable to optimize contract performance across a vendor or customer.

Conclusions

Inability to locate and analyze contracts results in poor internal controls leading to revenue and cost leakage. If an organization is unable to locate and analyze its contracts, it cannot analyze its business. For example, companies that are aware of all the contracts they have with a particular vendor are in a better position to negotiate volume discounts. Companies that are unable to locate all of their contracts with a particular entity are also unable to analyze their risk exposure with that entity.

Contract Creation

Businesses today place a high premium on productivity. To maximize productivity, they need to be able to create contracts with customers and suppliers as quickly as possible, while at the same time, minimizing risk.

Best Practices

To accomplish their objectives, organizations need to automate as much of the contract creation process as possible, by providing standard language and automated workflows that ensure procedures are followed and everyone within the organization has the tools they need to act quickly. In particular, the organization should be able to create contracts using standard templates that incorporate best practices—companies should know from experience useful formats, profitable terms and conditions, required supporting details, and information necessary for accounting systems. Standard formats streamline the contract development and review processes as well as minimize inconsistency and costly follow up.

However, in the real world, partners and customers frequently wish to make changes to standard contracts. As a result, organizations need a process to track deviations and ensure that appropriate approvals are obtained. Whenever someone wants to change a clause within a standard contract, the system should use automated workflows to automatically alert a member of the legal team to review and approve the change, thereby offering a foolproof way to prevent people from bypassing corporate contract approval procedures. The system should also incorporate audit trails and other tracking mechanisms for all contracts.

Results

Our research found that organizations are not coming close to adhering to best practices in the area of contract creation. Currently, 45 percent are dissatisfied with the current state of their contract creation process.

Companies are not adequately ensuring that their contracts minimize corporate risk. The first line of defense in minimizing risk is to use templates that contain standard contract clauses. Yet, 26 percent of companies surveyed do not use standard templates to create new agreements. Even when the company does use templates for standard clauses, language is frequently added to the contracts. This modification process can increase risk if the new language does not go through a risk evaluation process. Nonetheless, 34 percent of the companies surveyed have no risk evaluation process before sign off. The result: 63 percent of companies surveyed believe their contracts have language that increases corporate risk.

Conclusions

A broken contract creation process slows down sales and procurement processes and increases corporate risk.

Obligation and Commitment Management

Managing a contract through its lifetime is critical, since contracts essentially define the business relationship and the transactions that occur between the two parties. Because the ultimate purpose of a contract is to create a vehicle for transferring value in the form of goods and services between organizations, contracts governing that transfer need to be airtight.

Best Practices

By integrating the contract management system with procurement and sales systems and creating automated workflows among these systems, organizations can ensure that they closely adhere to the terms of their contracts. By following these best practices, organizations can:

- Maximize revenues. On the sales side, by linking the contract and sales systems, organizations can ensure that they collect all revenues to which they are entitled for services rendered. For example, organizations can more easily track when service contracts have expired, so they do not continue to provide service for which customers have not renewed their contracts.

- Minimize costs by minimizing procurement transactions outside of agreements. This way, for example, an organization can ensure that if one part of the organization negotiates good rates from a vendor, all groups within the organization take advantage of these negotiated rates. Additionally, by funneling all sales through a centralized contract and procurement system, an organization is better able to take advantage of volume discounts that may be specified in the contract.

- Keep up to date on contract expiration and milestone completion. Anytime a contract expires, there is an opportunity for purchasing organizations to negotiate volume discounts or for selling organizations to increase prices if the customer is demanding more service. A system that provides triggers and alerts for contract expiration and milestone completion allows organizations to take advantage of these opportunities. Visibility into milestones also may help companies avoid penalties that might be incurred from not delivering on time to their customers. It may also help improve customer relationships. Tracking milestones for their vendors allows companies to hold their vendors accountable.

Results

Companies are aware that better management of contracts can help them reduce costs and increase revenues in the form of overpayments or uncollected revenues. Indeed, 40 percent of companies surveyed believe they could realize a large or significant incremental savings opportunity in procurement costs by managing contractual commitments. Thirty-one percent believe there are large or significant incremental revenue opportunities to be had in managing sales contracts better.

Despite their awareness of the stakes, many companies are not adequately managing their commitments. Eighty-two percent of companies are concerned about managing commitments, while 45 percent of companies surveyed say they do not manage their negotiated terms across the enterprise—which means that parts of the organization conduct transactions at unfavorable rates.

Despite their understanding of the benefits of managing contract commitments, many companies are unable to do so. Milestone tracking is critical as missed milestones can trigger penalties or damage relationships among contracted partners. Nonetheless, 40 percent of companies surveyed do not have a reliable milestone notification process. Fifty-two percent of companies

Is Your Contact Management Process the Best in the Industry?

If you suspect that your organization is lacking in one or more key areas of contract management, take the following test to see how you stack up to industry best practices.

If you answer "no" to any question below, you should take the self-assessment benchmark survey and discover how you compare to current best practices.

1. Does your organization know the expiration date of all your contracts? Yes No
2. Could you easily locate any specific contract you are looking for and be able to do this for all of your contracts? Yes No
3. Are your financial systems updated whenever a contractual risk event occurs? Yes No
4. Are you certain that you are not losing any money due to cost leakages in your procurement contracts or revenue leakages in your sales contracts? Yes No
5. Can you analyze your contracts across a vendor, customer, or product? Yes No
6. Have all your contracts gone through the appropriate approval process before they were signed? Yes No

say they don't do a good job of enforcing terms, and 52 percent of companies do not know the expiration date of all their contracts, which can lead to business disruptions when procurement contracts expire and lost revenues when sales contracts expire.

A significant number of companies—43 percent—had more than 25 percent of their contracts renew automatically. On the surface, this may look like a bad thing for procurement contracts and a good thing for sales contracts. However, more than 90 percent of the companies said they do not closely track expiration dates of all their contracts. A contract renewal is an opportunity to revisit the terms on both the buy and sell sides and renegotiate them to the benefit of your organization. High auto renewal rates combined with a high percentage of undetected expiration dates means that companies are leaving money on the table.

Conclusions

If you are not actively managing your contract compliance, you are under-collecting revenues and overpaying costs.

Contract Risk Management

Whenever an organization deals with another party, it is exposed to risk. Recent focus on corporate governance has heightened the awareness around contractual risk. Organizations need to mitigate the risk if possible, or, at the very least, track the risk. When a risk event does occur, organizations need to communicate across the company to enable employees to respond as quickly as possible. Given increasing corporate scrutiny, companies also need to disclose to their board and investors their risk exposure specifically as mandated in the new Sarbanes-Oxley Act of 2002.

Best Practices

The following best practices allow organizations to meet these objectives.

- The company should be able to track all important contract risk elements, such as contingencies and interdependencies, as well as maintain an audit trail of who reviewed and signed off on those risks elements in the contracts and when they authorized them.

- When a contract risk event occurs, the system should use triggers to automatically update relevant managers. The contract system should integrate with financial systems and offer cross application workflows to automatically alert financial systems when a risk event occurs. For example, when currency exchange rates change in an area where the company has exposure through one of their contracts, the system should automatically alert managers and financial systems. By tracking risks closely, when an external event does take place, the organization can respond quickly.

- Improve disclosure of contract risks to outside agencies, regulators, and investors. When an organization is able to track risk, it can much more easily disclose risks honestly and accurately.

Summary of Key Points and Findings

- We were surprised to learn that 81 percent of the companies surveyed said that simply finding contracts was an area of concern. Additionally, 54 percent of the companies find it difficult to access specific terms and clauses without spending substantial time looking through the contracts. More than half the companies said they were unable to analyze their contracts by vendor, customer, product, or service line, which implies that they are not benefiting from full negotiating leverage or are unable to optimize contract performance across a vendor or customer.

- Contracts define the business relationship and transactions among parties, so managing a contract through its lifetime is critical. Yet, the area of managing contractual commitments was keeping contract professionals awake at night at 75 percent of the companies surveyed.

- The purpose of a contract is to create a vehicle for transferring value in the form of goods and services between organizations. Yet, 40 percent of the companies surveyed felt that they could achieve large savings in their procurement contracts by managing contracts better, and 31 percent of the companies surveyed felt that they could achieve large incremental revenue opportunities by managing sales contracts better.

- The recent focus on corporate governance has heightened awareness of contractual risk. Indeed, 75 percent of the companies listed contractual risk as a major area of concern. Nonetheless, few companies adequately track risks: 61 percent of the companies had no idea of the interdependencies between their contracts; 66 percent either did not or rarely tracked side letters; and 60 percent did not track their contingent liabilities.

- We were also alarmed to discover that more than 50 percent of the companies had no reliable notification process to alert the correct people to respond to the triggered risk, and 26 percent of the companies were dissatisfied with their level of risk disclosure in their financial reporting.

Results

Despite the fact that the recent focus on corporate governance has heightened awareness of contractual risk, our survey found that companies are not doing all they can to track and disclose their contractual risk; 75 percent of the companies listed contractual risk as a major area of concern.

To deal with risk, companies must either mitigate the risk, or if that is not possible, track the risk closely, and communicate risk events within and outside the organization. Yet, our survey found that companies were unable to track their contractual risk adequately; 61 percent of the companies had no idea of the interdependencies among their contracts, 66 percent of the companies either did not or rarely track side letters, and 60 percent of the companies did not track any contingent liabilities. This analysis tells us that two-thirds of the companies are doing a poor job of tracking their contract risk, creating risk exposure for their organizations.

Should a risk event occur, most companies are not prepared to respond quickly. More than 50 percent of the companies do not have a reliable process to notify the right people in response to a contractual risk event. Nor are companies able to track the financial implications of a risk event. For example, if a contract is cancelled, companies may need to make adjustments to revenue or cost items in their income statement. Yet, 40 percent have no reliable process to update financial systems should a risk event occur.

Despite the increasing demand for disclosing organizational risk (including contractual risk) to investors and regulators, when companies are unable to accurately track risk, they are unable to make accurate disclosures. Not surprisingly, 26 percent of companies surveyed are not satisfied with their current level of risk disclosure, and a significant 26 percent did not know if the reporting was adequate.

Conclusion

If companies are unaware of their risks, they cannot accurately make certifications and disclosures to investors and regulators

Overall Conclusion

Overall, the vast majority of companies are severely lacking in all areas of contract management, from creating contracts, to visibility and access to managing commitments and obligations to tracking contractual risk. If companies wish to speed their business operations, maximize their profitability, and reduce their contractual risk, they must carefully examine how well they measure up to industry best practices for contract management and create a plan of action for improving their own contract management operations. ***JCM***

Endnote

1. Application Delivery Strategies, The META Group, September 27, 2001.

Appendix A

Survey Methodology

We developed questionnaires for this survey based on the pain points we commonly encountered when working with customers. In designing the survey, we examined four key areas:

- Creating the contract,
- Storing and accessing contracts,
- Managing and tracking the terms of the contracts, and
- Managing contract risk.

We defined a set of commonly accepted best practices for creating, storing, and tracking terms of contracts based on a review of reports published by industry experts. These include reports by The Gartner Group, Goldman Sachs, and the META Group. (Subsequent sections detail these best practices.)

Next, we administered the survey to 100+ Global 2000 companies, asking them about their internal processes. We selected companies randomly from the following industries: pharmaceutical, insurance, consumer package goods, higher education, technology, software, Internet, services, transportation, government, banking, telecom, healthcare, industrial and others. Ninety percent of these companies are headquartered in the United States, while 10 percent come from Europe. Survey respondents came from across the organization, including senior managers, directors, and operational managers.

The results presented in this article represent an aggregation of survey results. We also compared individual companies to the scores of the top quartile of respondents. This gave individual companies a score based on how they compare to ideal best practices and to achievable best practices.

We believe our sample is a statistically representative sample of results from Global 2000 companies because we chose the participating companies randomly and because our results were consistent across all companies surveyed regardless of size or job function of the respondent.