

View Point



Actionable Insights

On Contract Performance Improvement

–Kaushik Rana

One of the most important items on Chief Procurement Officer's (CPO) dashboard is to get visibility into contract compliance to be able to bring more spend under management.

However, in spite of having contract management systems and contracts in place, many organizations are faced with buy-side contract non-compliance issues; maverick spending and non-contracted purchase order (PO) spend leading to savings leakage.

Organizations can benefit from using Contract Performance Management Maturity assessment framework to identify potential shortfalls in their contract management tools, processes and technology capabilities. Further investments in effective spend analysis capabilities with out-of-box reports; metrics and KPIs on contract compliance will improve visibility into non-adherence issues and identify bottom-line savings opportunity.

Introduction

In the last decade, many organizations have invested in contract management systems to improve their contract creation process. The objective is to shorten the cycle times by streamlining internal inputs and approvals, capture contract data appropriately and ensure compliance. A survey by Aberdeen Group (2007) has shown that a majority (58%) of enterprises have placed a high level of interest on the implementation of Contract management applications. However, in spite of having systems in place many organizations today are faced with a lack of visibility into contract usage data; leakage of contracted savings; missed payments, deadlines, lost discounts; inability to do spend analysis and related opportunity assessment. Aberdeen Group (2008) research has indicated that 49% of CPOs consider visibility into compliance as among the top strategies to bring spend under management.

Consider the case of a leading aircraft and industrial manufacturer who uses Ariba Contract Management solution for material procurement. When it comes to indirect material required for their operations, procurement is done on an ad-hoc basis using P-card since there is no robust contract performance management in place. So, for such transactions happening outside of a PO-based process, they are unable to track regularly purchased items which can be brought under a contract so as to obtain negotiated pricing and volume discounts. This gap can be mitigated by tying spend analysis with contract management and aggregating, classifying and enriching spend data to provide real-time enterprise level view of contract performance through reports, metrics and scorecards.

Contract Non-compliance

A contract between a purchaser and supplier broadly governs the terms and conditions of the trading relationship and is typically considered in legal disputes. Additionally a contract will include the commercial terms such as:

- Price
- Quality
- Delivery schedule
- Payment Terms
- Rebates/Discounts and Penalty conditions

Non-compliance by either party can result in a contractual default. Contractual compliance maybe open to interpretation by either party. For example, the price at which a purchase is made may differ from the contract price with the suppliers. Accordingly, this may be an example of non-compliance on the part of the supplier. While price is a key commercial term, following are some ideal contract non-compliance cases where companies end up paying a different amount to vendors than they planned, expected or contracted to spend

- Users/Buyers making purchases outside of preferred purchasing agreements such as outline agreements, long term blanket purchasing agreements and catalogues when they exist.
- Users/Buyers making purchases with suppliers with less attractive terms when more than one such agreement exists with more than one vendor for similar items/categories.

The cases of buying outside a contract in the regular procure-to-pay process (e.g., using SAP, Ariba, Oracle) when contracts exist are easy to identify. These are **non-contracted Purchase Order (PO)** spend items.

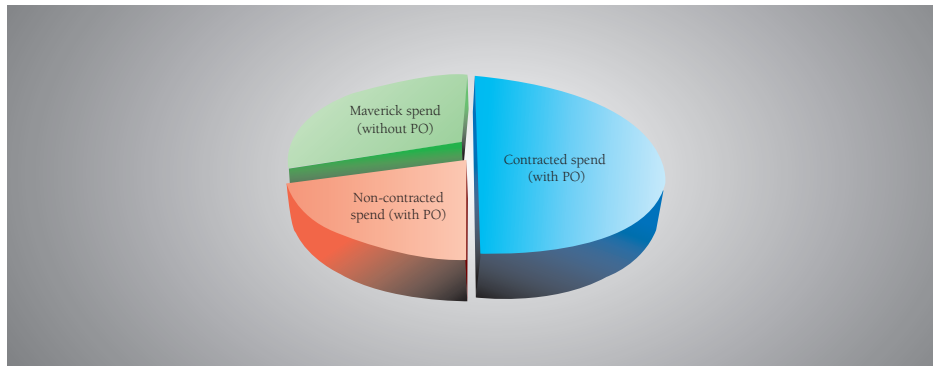
However, maverick spending does take place when buyers purchase materials outside of a contract (without a PO) in an alternate procurement process such as a procurement card or check requisitions (like the case mentioned earlier in leading aircraft manufacturer). Spend without both a contract and a PO is typically referred to as maverick spending. However, it is not true that every alternate channel of procurement (like P-card) is a case of failure to purchase under the existing contract. Few organizations use P-card to make the payment for a contracted item since vendors do not have the necessary infrastructure. Fig 1 on the adjacent page illustrates the terms.

So, non-contracted spend (with PO) and maverick spend (without PO) are both cases of contract non-compliance.

Causes of Contract Non-compliance

Contract non-compliance can happen because of multiple reasons:

Fig 1: Defining the Terms



- In case of multiple and independent business units (multi-industry companies), the different business units buying same or similar materials and not all of them are buying within a contract.
- In case of multiple and independent business units (multi-industry companies), the different business units having different contract agreements for same or similar materials with same or different suppliers.

However, much of contract non-compliance cases are because of not adhering to terms and conditions mentioned in the contract.

- Ordering quantity below the line item minimum quantity
- Paying penalty for making purchases below the volume threshold
- Not tracking spend properly and hence missing out on negotiated rebates (spend is less than the threshold value defined in contract).
- Non-uniform/ unfavorable payment terms across suppliers for similar commodities. Not utilizing the agreed upon credit terms.
- Procuring materials without a contract since cross-material comparison is not possible to identify items for potential contract (using common commodity classification or standard commodity classification like UNSPSC).
- Long term contracts not in place which can result in discounted savings for high value transactions across the different units.

A proper spend analysis program can help identify items which are not under contract and minimize loss in savings due to lack of contract compliance. By entering into long term agreements (LTA) with suppliers, organizations can derive benefits such as:

- Favorable price negotiations
- Reduce fluctuations in pricing
- Better sourcing strategies to award contracts to well qualified suppliers identified through a robust selection process
- Gain better control over quality of the products and services

Bartolini and Dwyer (2008) in their report *Spend Analysis: Pulling Back the Cover on Savings* recommends conducting regular audits of contract compliance. They write:

“Contract Compliance ensures that benefits from spend analysis and sourcing activities are realized. Savings leakage (the gap between identified and realized savings) is a significant concern for most procurement departments and often occurs due to poor contract processes and poor post-contract buying behavior. By conducting regular audits (performed by 46% of Best-in-Class), enterprises put in place a mechanism to help minimize savings leakage and identify maverick spend and thereby reduce it going forward.”

Fig 2: Contract Performance Maturity Assessment Framework

	Typical	Emerging	Advanced	Pioneering
TECHNOLOGY	<ul style="list-style-type: none"> Contract data not populated into the buying systems. Purchase orders are not systematically referenced to a contract Limited integration of contract repository to transaction systems 	<ul style="list-style-type: none"> Contracts are stored in a searchable electronic repository that provides alerts on contract expirations & other milestones Contract request and approval is enabled via electronic work-flow Data is organized and useful to develop reports to help drive decision making 	<ul style="list-style-type: none"> Electronic contract repository integrated with procurement execution systems Capability to provide real time, enterprise-level view of contract performance Utilize role based web reporting tools & dashboards to track key spend and access to contract data across the organization. 	<ul style="list-style-type: none"> Link spend analysis processes and tools with e-sourcing & contract life-cycle management to lock down spend and bring more spend under management Automate Expiry/renewal notification/compliance alerts; to take proactive steps to reduce maverick spending and avoid no contract situation.
PROCESS	<ul style="list-style-type: none"> Large percentage of ad-hoc, short term contracts Non-standard contract templates and no library of standard clauses; Long lead time and high administrative cost to create a contract, get approval & final negotiation 	<ul style="list-style-type: none"> Individual business units are involved in requirements definition and negotiations of contract. Usage of standard contract templates; maintain library of standard clauses An enterprise-wide process exists for contract request, negotiation, approval, execution and close-out 	<ul style="list-style-type: none"> Leverage spend data to identify transactions that are non-compliant to current contracts and identify maverick spend Ensure all non-price terms achieved in contracts are executed (discounts, rebates etc). Systematic and frequent granular spend analysis & compliance reporting 	<ul style="list-style-type: none"> Contracts are systematically evaluated at the end of their life cycle Perform regular audits of contract compliance – minimize contract leakage Collaborative partnership with central purchasing unit and suppliers for more long term contracts and volume discounts.

Assessing the Maturity of Contract Performance Management

Organizations can use the Contract Performance Maturity Assessment framework (shown in Fig 2) aligned by 4 increasing levels of maturity – Typical, Emerging, Advanced and Pioneering to determine the current state of their contract systems and processes. The framework can quickly help identify potential shortfalls in their current contract performance capabilities and identify best-practices from Advanced and Pioneering areas that will be a strategic fit towards realizing high-level of contract compliance.

Our experience with global organizations has shown that it is often difficult to track compliance performance and match forecasts to actual because of inaccurate data in multiple systems; data not stored in a structured manner in a central repository leading to poor contract visibility and access. Further, poor integration with enterprise and transactional systems result in contract outages, missed payment deadlines and discounts. Hence, it is imperative for organizations to invest in the right contract management technology that supports authoring, collaboration, monitoring, analysis and reporting. A central searchable contract repository shared company-wide with consistent templates and standard clauses and proactive alerts for contract milestones, expiry and violations will go a long way in ensuring compliance. Additionally an electronic workflow based request, amendment and approval mechanism will reduce the cycle time and streamline the contracting cycles. The above framework can effectively be used to assess both the current and the desired or required maturity of contract management technology, tool and process capabilities.

A leading CPG company has SAP Contract Management solution for sourcing and procurement. However, their contract management system is not properly integrated with their enterprise system. Buyers are often not aware of existing contracts having centralized price agreement and buy goods from vendors having a different price than which is given in the contract. Hence using the above framework they analyzed that their current contract performance can be labeled as **Emerging**. Their current reporting solution was highly labor intensive with limited capability to provide information to track spend or identify savings. They were looking for a reporting solution that will improve visibility to procurement data by integrating data from multiple backend systems and utilize role based web reporting tools to track spend and provide real-time contract compliance information – clearly a strategic direction to have **Advanced** Contract Performance management in the organization.

Contract Compliance Reporting

Leading organizations across the world are investing in spend analysis programs to gain visibility into spending patterns across product categories, locations, business unit and over time. The goal clearly is to identify savings opportunities within top spend categories; track contract compliance and limit maverick spend. For instance a detailed spend report by category can help identify percentage of spend under contracts, percentage maverick spend, spend percentage by catalog etc.

Chief Procurement Officers prefer having **Top 25 Maverick Spend Report** that lists top 25 items in descending order by Maverick spend (i.e. purchases/spend not controlled by PO/ Contract) value in the organization. It can provide corresponding details of invoice, spend amount and percentage value which can be used for further root-cause analysis on those items.

A **Contract Non-compliance Spend** report detailing products where purchase price does not match the contract price would list out the products non-compliant to contract. A Top 20 list of such items or a detailed list with invoice and percentage non-compliance spend will be useful to qualify lost savings from pricing errors, qualify missed savings opportunities from internal users not buying on contract and provide the ability to analyze offcontract spend by commodity, unit, category, and vendor. Additionally, a **Non-contracted PO spend report** (i.e. PO spend but without Contract) can enlist commodities/products with corresponding invoice details and spend value not having a contract. Analysis of this can help identify items which can potentially be brought under contract or check to see if items are already on-contract but was bought out of contract by the buyer in charge.

Leading procurement units often have a detailed **Contracted Spend Report** (i.e. spend under contract) that lists commodities/products with their total spend value with corresponding details of Contract, PO and Invoice. High spend value items can be identified and checked for possible price or contract negotiations with different suppliers.

Organizations are recommended to use out-of-box reports that can be used by procurement executives at different hierarchical levels to measure contract performance, drive compliance and identify opportunities for improvement across various dimensions (unit, vendor, category).

Contract Performance Metrics

Another important component of procurement organization's contract performance measurement is the set of quantifiable metrics and KPIs for which targets can be established and monitored against to enable continuous performance improvement initiatives with buyers and managers. For instance **percentage spend under management** is a high level financial metric monitored by the CPO to ascertain spend managed by the procurement group in comparison to the total spend of the organization. This indicates the percentage of spend under control through effective usage of e-procurement system, contract management; preferred suppliers, catalog usage and linking it with spend analysis.

It goes without saying that to bring more spend under management, the **percentage of spend under contract** should increase. This indicates the direct material, indirect material and services procured under contracts. Procurement units often focus on the direct material spend since this contributes directly to production and thus having a tab on the **percentage direct material spend under contract** can accelerate decision making in these categories. Conversely, the **maverick spend percentage (offcontract)** i.e. spend without a PO should decrease in order to bring more spend under management. Some of the genuine reasons for maverick spend is inability of supplier to supply in the given time or case of purchasing to meet urgent production order. Nevertheless, this metric and **contract compliance percentage** is closely monitored and used to identify savings opportunity. The **purchase price variance percentage** is often calculated to find the difference in invoice price vis-à-vis the contract price and determine corresponding loss in savings.

Further to this, some leading organizations use non-price items like missed discounts percentage or percentage volume rebates captured to further open up savings and compliance reporting avenues. Pioneering procurement units systematically review the contracts at the end of their period, set alerts for renewal or termination notification to avoid no-contract situation. Having metrics of percentage long term contracts (equal or more than a year) or percentage contracts getting renewed yearly gives insight into this aspect.

A leading CPG company with thousands of suppliers lacked access to accurate, timely and complete purchasing and information. Their current reporting solution provided limited information without the ability to track usage and analyze contract consumption data and a limited ability to track savings. Infosys identified gaps in current spend analysis, contract

management and savings metric usage for the client. We then prioritized the list of KPIs relevant to contract performance improvement, defined the KPIs, and linked them to a set of defined roles, established ownership and accountability. This transformational initiative is leading to a targeted savings of nearly 35-40 million dollars over a period of 5 years (excluding sourcing and other business benefits) through improved contract compliance and efficient analytics capability. In addition, the role based alerts have brought deviations to the attention of the users and helped them take initiatives for corrective measures in a collaborative environment.

Aberdeen Group (2008) survey (See below Fig 3) indicates that Best-in-Class (Top 20%) procurement units have 75% spend under management, 17% savings realized from sourcing efforts and 76% compliance to contractual agreements. Hence, procurement units are recommended to set up metrics and success criteria to effectively monitor and benchmark their contract performance.

Fig 3: Top Performers Earn Best-in-Class Status

Definition of Maturity Class	Mean Class Performance
Best-in-Class: Top 20% of aggregate performance Scorers	<ul style="list-style-type: none"> • 75% of spend under management • 17% realized savings from Sourcing efforts • 76% compliance to negotiated contractual agreements
Industry Average: Middle 50% of aggregate performance Scorers	<ul style="list-style-type: none"> • 60% spend under management • 9% realized savings from Sourcing efforts • 53% compliance to negotiated contractual agreements
Laggard: Bottom 30% of aggregate performance Scorers	<ul style="list-style-type: none"> • 55% spend under management • 5% realized savings from Sourcing efforts • 35% compliance to negotiated contractual agreements

Source: Aberdeen Group. October 2008

Conclusion

Leading organizations have central procurement units who regularly monitor spend and negotiate long term contracts to get volume or price discounts. They ensure that there is buyer acceptance, awareness and early communication of the terms and conditions of the contract. They also keep a check on the number of buying methods and levy penalties or lock down spending on alternate buying channels. It is important for organizations to ensure proper contract policy enablement, contract authoring, contract administration with an effective contract life-cycle tool that supports legacy contract data, integration with enterprise apps and master data management. So, a tight linkage between spend analysis programs, contract process management, data and technology can optimize contract performance and give a flip to bottom-line margins.

Bibliography

Patel, V., Dwyer, C. (Apr 2007). *Contract Lifecycle Management and the CFO: Optimizing revenues and Capturing Savings*. Boston: Aberdeen Group. <<http://www.aberdeen.com/Aberdeen-Library/3965/RA-ContractManagement.aspx>>.

Bartolini, A., Dwyer, C. (Oct 2008). *Spend Analysis: Pulling Back the Cover on Savings*. Boston: Aberdeen Group.<<http://www.aberdeen.com/Aberdeen-Library/4891/RA-spend-analysis-savings.aspx>>

Leavitt, P. (Mar 2009). *Best Practices in Contract Management*. APQC. <<http://www.apqc.org/knowledge-base/documents/best-practices-contract-management>>

Upside Software Inc. Aberdeen's *Best Practices in Contract Management* <<http://www.cylon.co.za/Downloads/Aberdeen%20Best%20Practices%20in%20Contract%20Management%20-%20Template%20v2.pdf>> (accessed on 13th Jan, 2011)

Gupta, R., Karayil, A., Rajendran, R. (Oct 2008). *Contract Lifecycle Management: The DNA of Procurement*. Bangalore: Infosys Technologies Ltd. <<http://www.infosys.com/supply-chain/white-papers/Documents/contract-lifecyclemanagement.pdf>>

Schemm, P., Philip, L. (2006) *Maximizing Value Through Contract Compliance*. Black Ink Solutions <http://www.pappainc.org/events/Maximizing_Value_Through_Contract_Compliance.pdf> (last accessed on 13th Jan, 2011)

About the Authors

The author, [Kaushik Rana](#), is currently Senior Associate with Infosys Consulting - Manufacturing Practice. He is APICS CSCP certified supply chain professional with over 10 years' experience in delivering value to clients in areas of procurement consulting, supply chain visibility solution and supply chain process analysis. He can be reached at kaushik_rana@infosys.com

Did you know ?

Infosys among the world's top 50 most respected companies

Reputation Institute's Global Reputation Pulse 2009 ranked Infosys among the world's top 50 most respected companies.



About Infosys

Many of the world's most successful organizations rely on Infosys to deliver measurable business value. Infosys provides business consulting, technology, engineering and outsourcing services to help clients in over 30 countries build tomorrow's enterprise.

For more information about Infosys (NASDAQ:INFY), visit www.infosys.com.

Global presence

Americas

Brazil
Nova Lima
Canada
Calgary
Montreal
Toronto
Mexico
Monterrey
United States
Atlanta
Bellevue
Bentonville
Bridgewater
Charlotte
Detroit
Fremont
Hartford
Houston
Lake Forest
Lisle
New York
Phoenix
Plano
Quincy
Reston

Asia Pacific

Australia
Brisbane
Melbourne
Perth
Sydney
China
Shanghai
Hangzhou
Hong Kong
Central
India
Bangalore
Bhubaneswar
Chandigarh
Chennai
Gurgaon
Hyderabad
Jaipur
Mangalore
Mumbai
Mysore
New Delhi
Pune
Thiruvananthapuram
Japan
Tokyo
New Zealand
Wellington
Philippines
Metro Manila
Singapore
Singapore

Europe

Belgium
Brussels
Czech Republic
Brno
Prague
Denmark
Copenhagen
Finland
Helsinki
France
Paris
Germany
Frankfurt
Stuttgart
Walldorf
Ireland
Dublin
Italy
Milano
Norway
Oslo
Poland
Lodz
Spain
Madrid
Sweden
Stockholm
Switzerland
Geneva
Zurich
The Netherlands
Amsterdam
United Kingdom (UK)
London

Middle East and Africa

Kingdom of Saudi Arabia
Riyadh
Mauritius
Reduit
UAE
Dubai
Sharjah

For more information, contact askus@infosys.com

www.infosys.com

© 2011 Infosys Technologies Limited, Bangalore, India. Infosys believes the information in this publication is accurate as of its publication date; such information is subject to change without notice. Infosys acknowledges the proprietary rights of the trademarks and product names of other companies mentioned in this document.