Disrupting the contract management paradigm

Thinking digitally, managing with clarity

KPMG International

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A contract's lifecycle is a well-trodden path that typically requires a large amount of work being put into the upfront **pre-signature** activity, such as contract formation where obligations and their associated performance indicators and service credits are determined. We then often see a shift **post-signature** where much of the intended value of the contract is lost through value leakage or forgotten through inadequate obligation management. The focus of the supplier and contract management team is also often exhausted on low value and manual activity due to lack of automation in the key pillars of *performance management, contract management, financial management and risk management.*

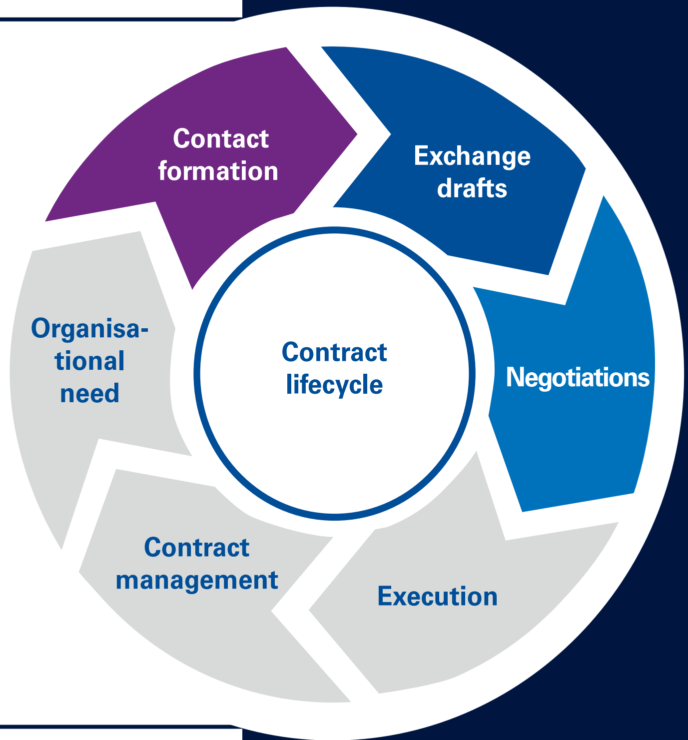
How can this issue be addressed?

The success of a third party relationship relies upon the foundation it is built upon pre-signature and then the execution of the contract management design post-signature. By thinking practically when contract management is working well, the client organization can receive the goods or services they expect within the time and at the cost that they expect. Effective contract management can keep the contract "alive" and "evolving", enabling new capabilities to be delivered to the client organization whilst maintaining integral value. The challenge is that many contracts are not fit for purpose and remain dormant, decreasing in relevance as each year passes and eroding and leaking value. They often measure the wrongs things and fail to evolve as the relationship and the services/capabilities develop.

So, let us look first at the pre-signature phases of contract formation: exchanging drafts and negotiations.

Organizations can reduce value leakage in the early stages of the contract lifecycle through:

1. Developing contracts that accelerate the procurement process
2. Employing a relationship-based methodology
3. Negotiating for value, not position
4. Leveraging data to inform strategy



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Develop contracts that accelerate the procurement process

An organization's contract set can materially impact the cost and total time to contract. In many cases, the benefits of maintaining aggressive "standard terms" are outweighed by the burden of having internal teams tied up in lengthier negotiations, contracting delays and the inevitable strain on the relationship. Even where a business has significant market or buying power (and the temptation to maintain one-sided contractual terms can be high), organizations should still consider the direct and indirect costs incurred, which can quickly outweigh the tangible benefits.

Businesses should shift focus to terms that are more likely to be achievable and are genuinely aligned with project outcomes. This avoids the traditional 'negotiate to the middle' process, where unnecessary time (and cost) is taken to achieve a predicable contractual outcome. For vendors negotiating customer deals, contracting delays have a direct and measurable impact on revenue. For buyers, contracting delays increase procurement and project costs and can delay important cost-out or customer initiatives.

Adopt a go-to-market process that is relationship-focused rather than purely transactional

We often see businesses take a positional approach to negotiating which directs effort and attention to clauses that do not have a significant impact on business outcomes or results. The over-emphasis on obtaining positional wins often results in parties missing the opportunity to find workable middle-ground.

Adopting a positional approach can also mean less attention is paid to mechanisms that impact project outcomes (e.g. accurately capturing the responsibilities of each party) and inherently delays the contracting process.

It is important to develop clear and achievable objectives before the commencement of negotiations (e.g. clear time frames for negotiations and an understanding of the true must-haves) and help ensure objectives for negotiations align with the businesses' overall strategic vision.

Clear objectives can arm the negotiating team with the knowledge of the positions that they should maintain and those that can be traded for an outcome that better suits the business.

Having a well-thought-out playbook can also allow organizations to extract significantly greater value out of their contracting suite. A play book allows an organization to have pre-determined responses (that are approved by stakeholders) for positions that are likely to be raised by the other side. This system can allow an organization to respond to a contractual mark up in a much timelier manner.

Focusing on the relationship with the service provider can help ensure outcomes are aligned with the ultimate success of the organization and encourage vendors to innovate and leverage best practice.

Negotiate for value rather than position

Going into negotiations with a clear understanding of your objectives and intended outcomes can help ensure that your organization does not fall into the top of taking an overly positioned approach.

Using historical data to identify key touch points and accurately understanding the organization's historical pain points can empower businesses to develop a deeper understanding of genuine business needs and project outcomes. This can help drive more positive negotiation processes where businesses don't need to take a zero-sum approach.

Across an organization's contracting portfolio this can translate to material cost savings considering the investment required from sales, procurement and internal (and external) legal in the process. Businesses should weigh these costs against the practical benefit of having certain clauses in the contract. (e.g. a business may decide it is not worth pursuing a certain warranty given the delays and costs it is likely to add to the negotiating process).

	Traditional transactional model	Relationship-focused model
Contracting model	Complex structure limited flexibility, difficult to introduce new services	Modular, flexible, easy to introduce or remove service lines
Commercials	Commercials are based on FTEs or other input-based measures	Move to output-based measures (such as transactions processed, or business results achieved)
Performance	Focus on compliance with services levels and completing activities with no risk or reward sharing	Focus on the customer and achieving business outcomes with risk and reward sharing
Delivery	Services managed through heavily stipulated and defined statements of work	Service partner who has "freedom within a framework"
People and governance	Complex contractual governance model but limited clarity over who has accountability and responsibility for outcomes	Simplified operating and governance model
Perception	Service partners is not perceived as part of the business, inflexible and does not continuously improve for mutual benefit	Service partner immersed in the customer's business agile in their approach and puts innovation at the very core of how they deliver

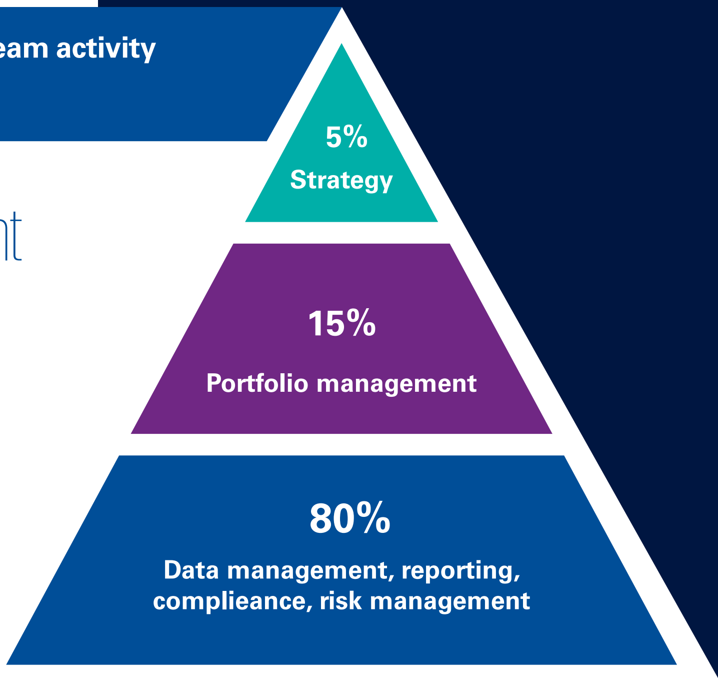
Leverage data to inform your contracting and negotiation strategy

Leveraging data across both the contract formation and negotiation phase of the contract lifecycle can contribute towards minimizing value leakage.

We will now shift our attention to **post-signature** activity when the contracts are typically handed over to the supplier management and contract management team. From KPMG member firms' extensive work across the post-contract signature space, this is typically the picture we see:

Typical supplier and contract management team activity breakdown

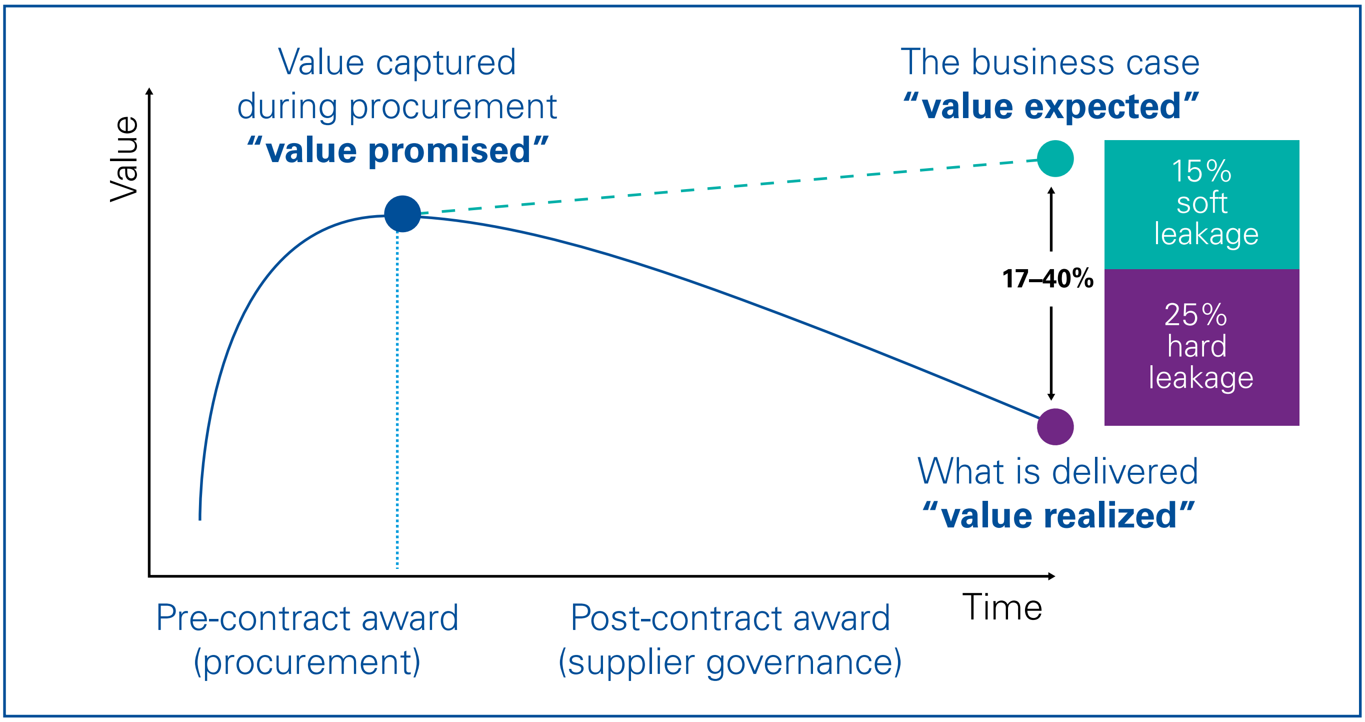
Up to 80% of supplier management time is exhausted in data management and reporting, leaving less time for portfolio management and strategy development



Essentially, the supplier and contract management teams are lost in the weeds of data management, reporting compliance and basic risk management activity. This leaves very little room for portfolio and strategy management where the true value of third party relationships can be unlocked. The lack of portfolio and strategy management can often result in value leakage, which can have a material impact of the third party arrangement in place when compared to the underlying business case.

Value leakage

Private and public sector organizations should recognize the story told by the chart below.



The loss of value can be attributed to the following:

- **Overpayment**
- **Unchecked consumption**
- **Unclaimed credits and discounts**
- **Scope creep**
- **Loss of focus on improvement and innovation**
- **Unclear accountabilities**
- **No holistic view of supplier performance**
- **Transactional relationships**

So how can this value leakage be stemmed, and the true value of the third party contracts be unlocked? This can be summarized across six pillars, the first two of which we have covered in the pre-signature phase outlined previously:

— embedding a relationship-based contract
— negotiating for value, not position
— obligation management as an ongoing discipline, ideally supported by smart contracts and AI
— performance management which is underpinned by autonomous technology
— financial management which links to the performance of the obligations in place and the commercial model
— risk management as an ongoing and integrated element of supplier and contract management.

Looking firstly at **obligation management**, which ideally sits at the epicenter of the third party relationship and evolves over time. Obligation management is supported through smart contract lifecycle management. All too often the term smart contracts is used for a technology implementation which moves the contracts from physically stored to virtually stored. This is not however the full capability of what smart contracts have to offer. A true smart contract capability digitizes the obligations, often semi-autonomously, into a series of workflows which are then able to be assigned and tracked as part of the supplier and contract management function.

Smart contract lifecycle management

What does smart contract lifecycle management mean? All too often, we see this being used as a metaphor for technology implementation that will be the panacea for all things contract life cycle. Through KPMG member firms' extensive work across this space engaging with contract management functions and specialists globally, CLM is viewed as a fundamental shift in the enterprise operating model, with technology as an enabler.

We forecast that over the next 5 years we will see the digitization of the majority of all contracts. Once in place, it is expected that this will have profound impacts on the way contracts are designed, created and managed. Obligations will no longer be static in written form, but live workflows which connect the obligation with the targeted business outcome and its associated set of owners.

Artificial intelligence can interpret and digitize both legal and operational obligations, enabling deeper contract analytics and faster contract updates to be created and approved.

If we have an established business need for digitizing obligations — then AI could support pre- and post-award decisional questions, environmental and requirement changes — but a point of reflection here — questions the role of the human interface (contract manager) and are those traditional relationship paradigms ready to pass the baton to AI, and then metamorphize contract managers into AI contract moderators? This question maybe not be so difficult to answer — if we take a view that AI empowers contract managers, adding value through efficiency in repetitive processes, and can be controlled through establishing governing rules.

If we can acknowledge that there are mutual efficiency benefits for both parties and the entire body of contract content and process data is captured in high resolution within a robust contract lifecycle management system, then could we state that we are now moving to a strategic function, knowing that operational and legal contract functions are being continually monitored by AI. If this holds true, then not only could we state that we have a smart contract, but we have a living contract, one that is capable of interacting with other software, users and even contracts — taking new actions that are independent of users based on predefined parameters or rules.

Performance management and financial management

The fourth and fifth pillars of the contract management framework are very much intertwined. The performance of your third party suppliers has a direct correlation with both the financial elements of the contract (service credits, invoicing, volume discounts etc.) and ultimately both the operational and financial performance of the organization itself.

KPMG member firms are often engaged with contract management teams who spend a significant amount of time verifying performance and financial data. While the outcomes of this activity are important, often the journey to get there is very manual and highly inefficient.

The new world of contract management requires a more efficient and effective approach to these two areas. High performance organizations are turning to supplier management and governance platforms to automate processes and centralize supplier performance into a single pane of glass view.

These platforms enable both a 50,000-foot view of the supplier portfolio for the executive while also enabling deeper supplier performance analytics at the operational level. This can enable better and quicker decision-making and ultimately increased levels of performance when managed correctly.

The performance data is then used as part of the invoice verification process. Some platforms even go so far as to creating pro-forma invoices within the governance platform to compare to the invoice provided by the supplier, which is a new level of efficiency and accuracy.

Embedded risk management

The final piece of the contract management puzzle is embedded risk management. In our experience, this is an area that is often overlooked until it is needed or at times until it is too late.

We saw broader supply chain challenges when COVID-19 took the world by surprise, impacting supply chains around the world and closing whole regions.

What learnings can we take from these interrelated events in how we approach supplier risk?

There are four core areas of supplier risk management, which when managed correctly can have a significant impact on the mitigation of risk:

1. **Holistic risk management**
2. **Risk management currency**
3. **Ownership**
4. **Automation**

Firstly, the supplier risk management framework should take a holistic view of supplier risk. Often, we observe organizations focusing on just the traditional areas of supplier risk, such as financial due diligence and BCP. The assessment of risk needs to be broader and deeper than this and include areas such as legal, operations, and geography, to name a few.

Secondly the assessment of supplier risk needs to be kept current. In other words, supplier risk needs to be assessed on a regular basis. Ideally, the supplier risk function should also be supported by live feeds of changes across the supplier portfolio, which could be from any of the risk types above.

Once a structured framework is in place and a regular cadence of assessment is established, it is also integral that ownership is defined. This does not relate to overall ownership of supplier risk, rather the next level down, where there is an established RACI and ownership at the task and output level.

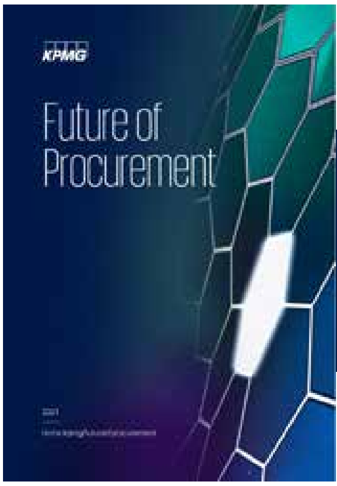
Regulatory/ compliance risk	— Regulatory requirements — Theft/crime/dispute risk — Fraud, anti-bribery and corruptions/sanctions	— Compliance with internal procedures and standards
Strategic risk	— Service delivery risk — Expansion/roll-out risk — Mergers and acquisitions	— Alignment to outsourcing strategy — Intellectual property risk
Subcontractor risk	— Applicable across all risk areas	
Concentration risk	— Supplier concentration across critical services — Industry concentration (including subcontractor)	— Concentration of critical skills (i.e. tech support) — Geographic concentration — Reverse concentration
Technology/ cyber risk	— Information security — Cyber security — Data privacy/data protection	
Country risk	— Geopolitical risk — Climate sustainability	
Financial viability	— Financial risk from lending to a third party — Liquidity risk	
Operational/supply chain risk	— Business continuity — Disaster recovery — Physical security — Operational resilience	— Performance management (including SLAs) — Model risk — Human resources risks (conduct risk, etc.)
Reputational risk	— Negative news — Lawsuits (past and pending) — Brand of the third party	— Key principals/owners of the third party — Workplace safety
Legal risk	— Jurisdiction of law — Terms and conditions of the contract	

Source: Third Party Risk Management Outlook 2020, KPMG International

Finally, to help ensure supplier risk is managed in an efficient and effective way, automation of the supplier risk management process is integral. This means moving out of the spreadsheets and into something more robust, such as a supplier governance platform. Here you can dissect supplier risk into a portfolio of tasks, checks and outcomes which can then be assigned to owners as part of the workflow.

Unlock the potential in procurement

The majority of organizations and functions are aware that the future can require different and flexible operating models to keep pace with the changing landscape. Technology disruptors should naturally drive the automation of low-value tasks, moving the workforce to higher value activities such as category innovation. However, even these higher-value activities will likely require a high degree of cross-skilling to allow the workforce to flex based on current priorities. In other words, having category managers managing one category in an endless loop is expected to become rare.



Read more about what the future of procurement looks like at home.kpmg/futureofprocurement.

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Faced with empowered customers, emerging technologies, cyber threats, severe periodic disruption and a battle for skills, CPOs face important questions:

— How can procurement help unlock transformation?
— Can I be a better partner to my business
— How do I move away from a mix of models and processes?
— Can I drive value with richer spend analytics?
— What is the best way to make change happen smoothly?

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Designed by Evalueserve | Publication name: Disrupting the contract management paradigm | Publication number: 137455-G | Publication date: July 2021