The value-based approach to managing contracts

Continuous improvement in the procurement and contract management functions.

By Brett Petersen, CPA, ACS CP

Context

IT outsourcing, particularly for infrastructure and related services including service desks, is undertaken by organisations for a variety of reasons, ranging from reducing costs and risk through to obtaining the advantage of innovative and new technologies. Whatever the reason, extracting optimal value goes beyond undertaking a sourcing activity and transitioning the contract into BAU 'set and forget' mentality.

As corporate budgets continue to get squeezed, fewer resources are allocated to managing the contracts.

On the surface and in the short term, greater efficiency of overheads (as contract management is often categorised as) appears to be achieved, but dig below the surface and a whole of range of risks and missed opportunities begin to materialise. Let's look at what this means in further detail.

The executive

In the short term, looked at through the lens of the executive, everything is as it should be. We are keeping our corporate costs down in managing the contract and we are further leveraging our resources.

Finance manager

Processes for converting contractual data into budgets is a manual and time-consuming activity, and often there is no audit trail of business rules and assumptions in conducting these tasks.

Further, ongoing chargeback and journals are conducted using makeshift spreadsheets before being manually input into finance systems.

Contract administration staff

Common issues include:
- Process for verifying invoice and supporting data not documented, so checking tasks based on staff knowledge of process (often incorrect)
- Staff not given appropriate handover and lack understanding of contract metrics to be validated
- Contract change process relies on manual communications and transfers of information, so often checking process is based on outdated information.
- Methods for verification are manual and time consuming, so only occur on infrequent and sample basis.

Sourcing and procurement staff

Sourcing and procurement for IT outsourcing deals is often undertaken by consultants and advisors, who are paid to negotiate an outcome. Expertise on the intricacies of the contract often walks out the door when the sourcing activity is completed.

In conducting the sourcing activity, an analysis is often undertaken of the 'base case'. This can be a very resource-intensive activity due to no concise single record of historical data. This information is usually kept in a number of spreadsheets and unstructured files.

A risk-based approach

Based on my experience (and validated with colleagues) there is often an error rate in favour of the vendor of between 0.3 and 0.6 per cent. This represents $300,000 to $600,000 for every $100 million in total contract value (TCV), which compounds over time and can represent as much as $3 million over a typical five-year contract.

The most common sources of errors relate to:

Incorrect rate being applied: this is usually as a result of contract changes affecting the rate not being applied or specific metrics from the contract being applied. For example, unit rates changing when volumes are outside a certain range.

GST related issues: vendor staff entering GST incorrectly, usually relating to excluding GST when it should have been entered into the invoice system as 'including GST' or vice versa.

Duplicate charges: usually relating to assets being billed for twice in same month or service desk tickets being charged multiple times.

Assets overcharging: assets continuing to be charged beyond contracted period (usually lease end date or end of useful life).

Service credits not being applied: where there are breaches of service levels, due to reliance on vendor data and/or client staff not calculating service credits as part of validation process.

Compounding the issues associated with this high error rate is that fact that when left

unchecked, the errors continue to accumulate on a monthly basis. Contracts also often contain a 'claw back' clause to the beginning of the current year for obtaining cost recovery or service credits.

While at face value 0.3 per cent to 0.6 per cent errors may appear to quite low when converted to a cost to the organisation, and it may seem like a risk worth taking. However, other considerations that may lead to a financial impact also need to be looked at. These considerations include:

- the cost of manual and labour-intensive processes to the organisation in at best only partially checking the invoice data.
- the cost of having consultants develop base case models having to trawl through reams of spreadsheets.

This invariably means account management is consumed in detailed, backwards-looking checking processes and issues management, instead of focusing on strategic partnering (which is much more fun and adds the most value!).

A value-based approach

This leads us nicely to exploring a value-based approach to managing contracts. Here are some practical tips to obtaining optimal value from your outsourced vendors, so they can be seen more as strategic sourcing partners:

- Have a single 'source of truth' for contract metrics, to enable accurate and automated verification and checking of invoice support data.

> As part of your procurement activity, look to simplify the metrics against which you manage the contract

- Integrate your checking process with existing systems. For example, set up processes so that additional assets included in each month's invoice are checked against corresponding service requests or purchase orders from your service desk or ordering system. Or, have a process that automatically checks user IDs from service desk tickets against your active directory.
- Have business rules that map the invoice item codes to your general ledger providing budgets and chargeback journals for your finance system, with the ability to drill through to source data when and as required.
- Have your data held in a system that provides 'big data' analytical and reporting capability to enable you to perform cost forecasting, budgets, and 'what if' and scenario analysis. This system can then also support procurement activity by providing updated and automated baseline values.

As part of your procurement activity, look to simplify the metrics against which you manage the contract, such as moving to an outcomes-based system. Examples include moving to headcount and fixed price arrangements with a greater focus on business performance criteria such as availability.

A system that could encapsulate both the risk and value-based approaches to managing outsourced contracts could be summarised like this: by establishing the described practices and by utilising technology in an innovative way, organisations can then genuinely create sustained efficiency gains, providing the added value of improved strategic vendor relations and a clearer understanding of cost drivers, where and how costs are consumed (strategy and decision support).

Opportunity

As part of ongoing continual improvement, organisations have an opportunity to reduce administrative costs associated with managing contracts, improve the accuracy of invoicing through 'root cause' analysis at the source, as well as support management reporting and analysis in automated and accurate ways.

Performing all of these improvements doesn't have to be an expensive and resource-intensive activity. What it does require is a genuine intent to improve on the status quo and the ability to employ innovation and technology in a risk-managed way. ∎

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