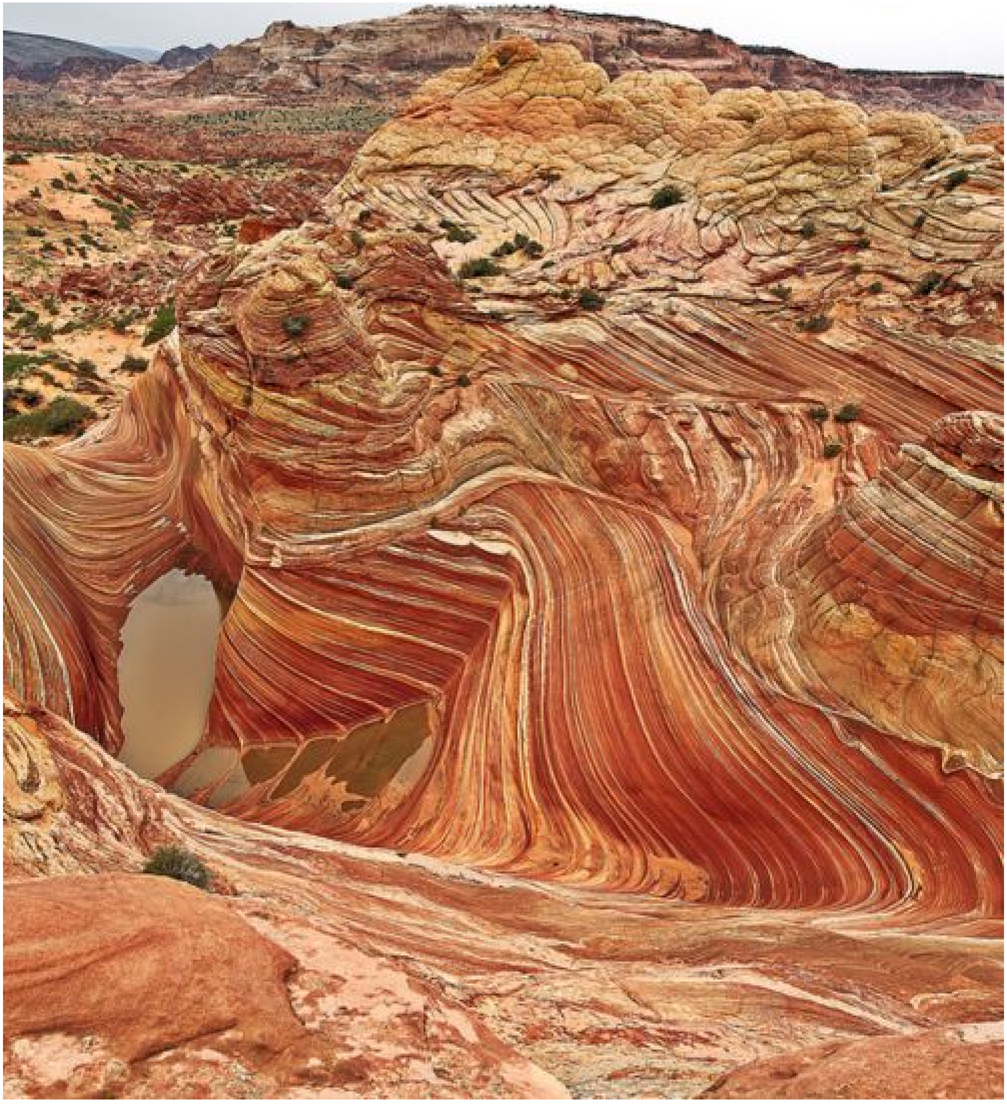

TACKLING EROSION:

Restoring Value to your Contracts

ABSTRACT

Only 48% of organizations are 'good' at monitoring in-life financial performance of their contracts.

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This survey was conducted in October 2020 and received input from 475 organizations.

About World Commerce & Contracting

World Commerce & Contracting is a not for profit association active in over 170 countries, with a mission to improve the quality and integrity of trading relationships. With more than 70,000 members representing over 20,000 organizations, the association is dedicated to raising individual, organizational and institutional capabilities in contracting and commercial management. It achieves this by providing research, benchmarking, learning, certification and advisory services to a worldwide, cross-industry audience of practitioners, executives and government.

Executive Summary: Describing the Problem

We start from a position of weakness. Less than half of the organizations responding to this survey consider themselves 'good' at monitoring in-life contract performance – and without timely and reliable performance data, it is difficult to identify problems and tackle the sources of risk.

This report provides insight to the factors that make our contracts 'risky' and describes the consequences of inadequate insight and controls.

Only 48% of organizations are 'good' at monitoring in-life financial performance of their contracts

Winning, awarding and performing contracts lies at the heart of business success. They drive revenues; they manage spend; they potentially deliver value, innovation and differentiation. Success depends on many factors – so it is perhaps inevitable that there is value erosion, a shortfall between aspiration and reality. Yet there is dramatic variation in the extent of that short-fall and, in this report, we explore the factors that underlie that variability.

We also expose the extent of variation – between industries, between types of agreement and – perhaps most tellingly – between buy-side and sell-side competence. Better contracting can deliver major benefits to every organization, but to some more than others. We seek to answer key questions around value erosion and opportunity – where it exists and how it can be improved.

Less than 40% of buyers are 'good' at monitoring and managing supplier obligations

What puts achieving contract value at risk?

Uncertainty is the single biggest threat to realizing contract value. It is an endemic issue, over 70% rating this as very or extremely significant. But it is not the pandemic that lies at the root of this uncertainty. It is lack of clarity around scope or specific commitments, far outpacing the 36% who (even in this time of COVID-19) see the unpredictability of market conditions as a major source of risk.[1]

A variety of risk factors frequently contribute to contract value under-performance. They represent a combination of 'uncertainty' and 'complexity' – for example, as Chart 1 indicates, the need to handle multiple performance obligations is viewed as the second most significant issue.

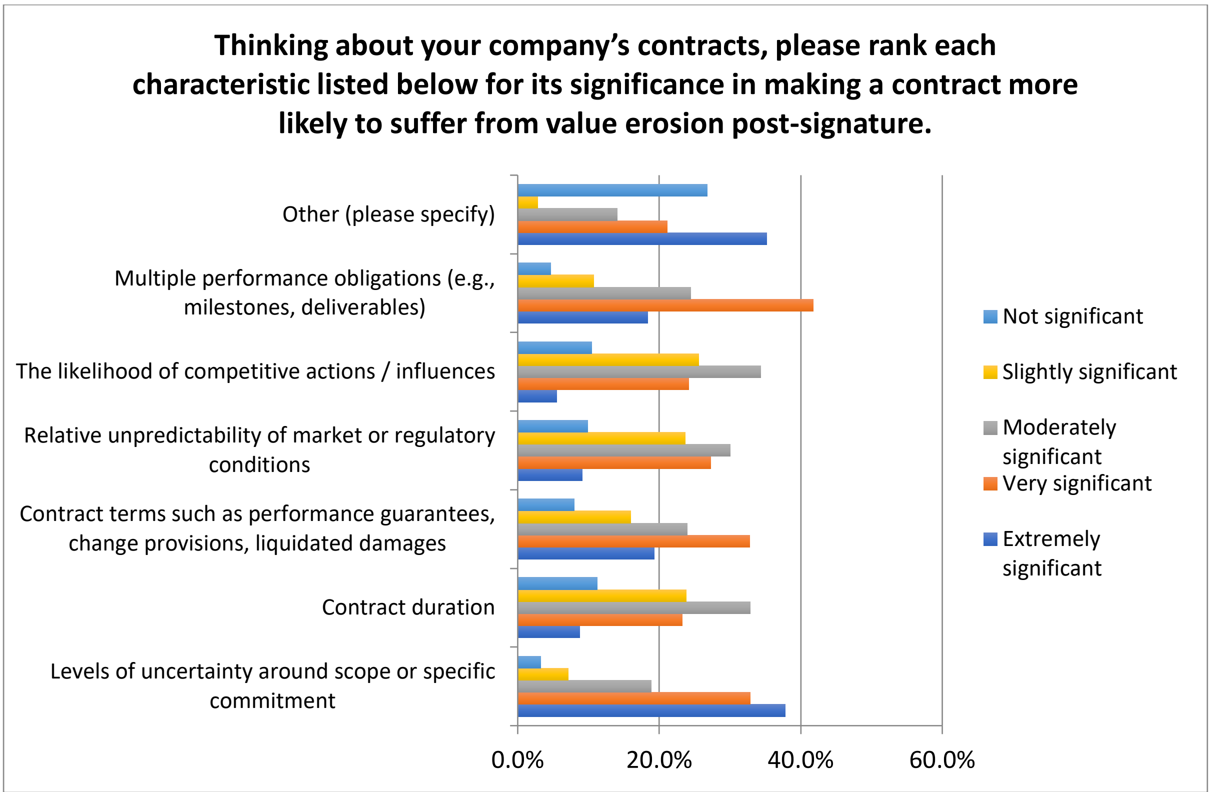

Chart 1: Risk Characteristics

However, it is not only uncertainty over scope definition that threatens performance. More than 50% of respondents highlight the risk of erosion occurring due to over-commitment by suppliers, which in turn makes the extent of financial guarantees and penalties a source of risk.

In the category 'Other', general weaknesses and lack of adequate discipline in post-award contract management are also highlighted by many respondents, both buyers and sellers.

The chart reflects an average and this disguises significant variations between countries and industries over the nature and perceived severity of risk factors. To illustrate this, Chart 2 provides insight to the issue of scope uncertainty from a country perspective, on a scale where zero represents 'not significant' and 4 represents 'extremely significant'. While we must allow for some distortion based on the number of country-specific responses and the industries represented, the chart indicates that the risk of scope and commitment uncertainty is universal, but of variable

[1] World Commerce & Contracting published a report on Uncertainty Management in 2019 – see https://www.worldcc.com/Portals/IACCM/resources/files/10991_iaccm-post-award-summary-report.pdf

significance. Similar variations are found across the other risk factors. While it would be easy to speculate about possible reasons for this, further research will be required to provide reliable insight.

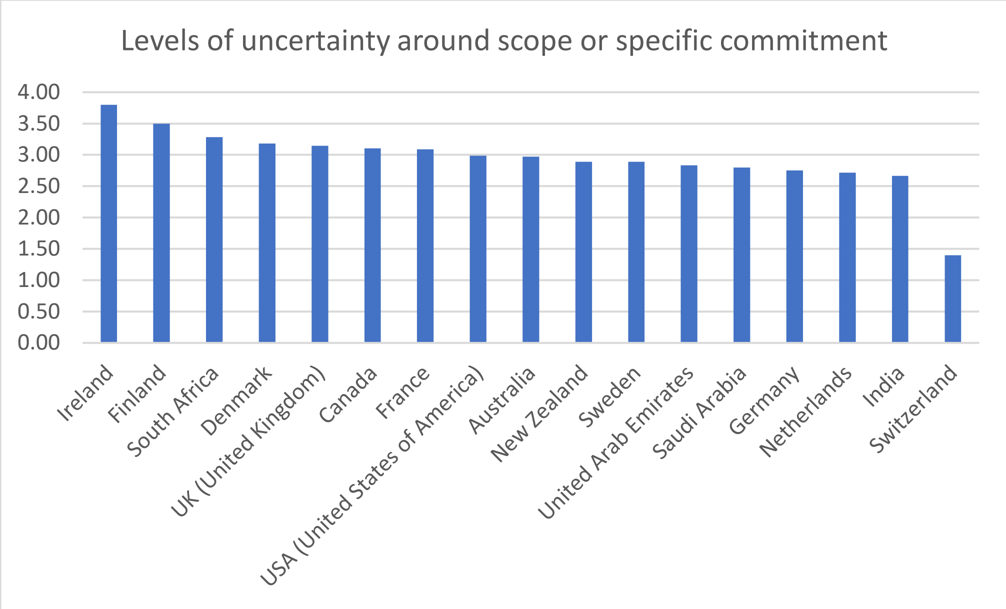

Chart 2: Levels of Uncertainty Around Scope – Country Analysis

The industry-based analysis of this same risk factor – shown in Chart 3 below – reveals similar variability in perceived significance of scope uncertainty. However, it should be noted that the issue of significance does not directly relate to the frequency of occurrence. Taking Aerospace and Defense as an example, the risk significance of scope uncertainty in such a high-risk and heavily regulated industry is high (scoring 3.3 on the scale), yet the frequency with which it occurs is substantially lower (scoring 1.6).

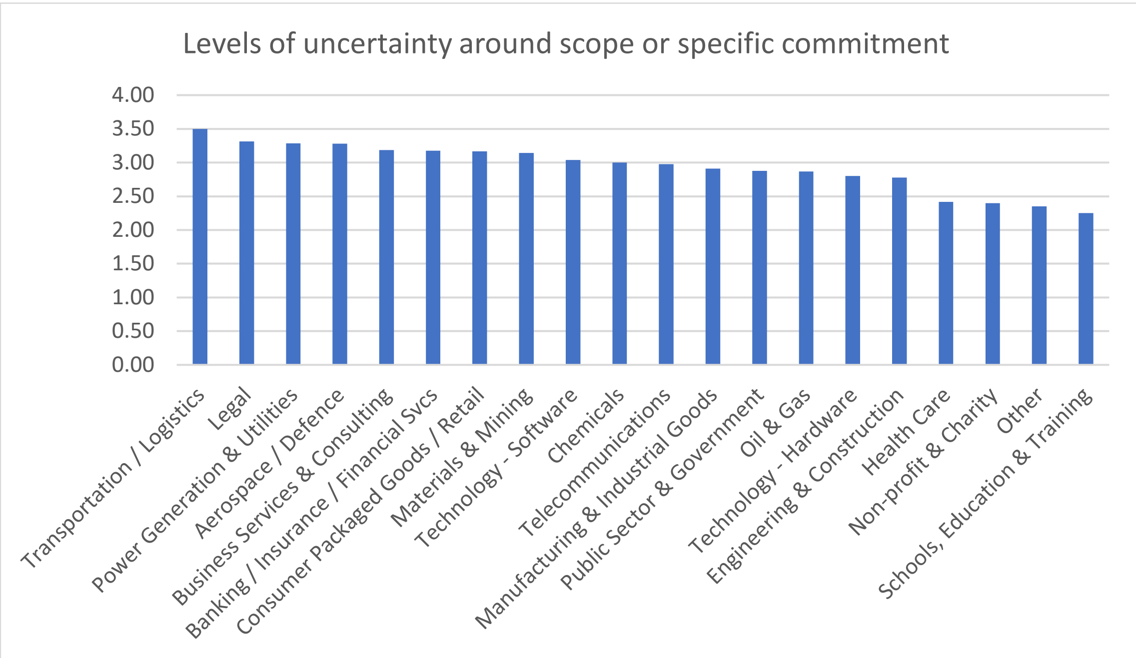

Chart 3: Levels of Uncertainty Around Scope – Industry Analysis

How do risks manifest themselves?

Chart 4 below shows how the identified risk factors manifest themselves for suppliers. Here, factors such as over-commitment and innate complexity are impacting subsequent delivery and resulting in liquidated damages, credits and delays in payment. However, issues around scope are still strongly evident and represent overall the most frequent disconnect, with the ever-present possibility that this translates to additional specification or performance requirements which may not be fully recovered. The absence of effective post-award contract management is also evident in the third most frequent issue, 'Failure to enforce rights or benefits of contract (e.g. chargeable change, price escalation clause)'. 58% cite this as material or very significant in contract value erosion.

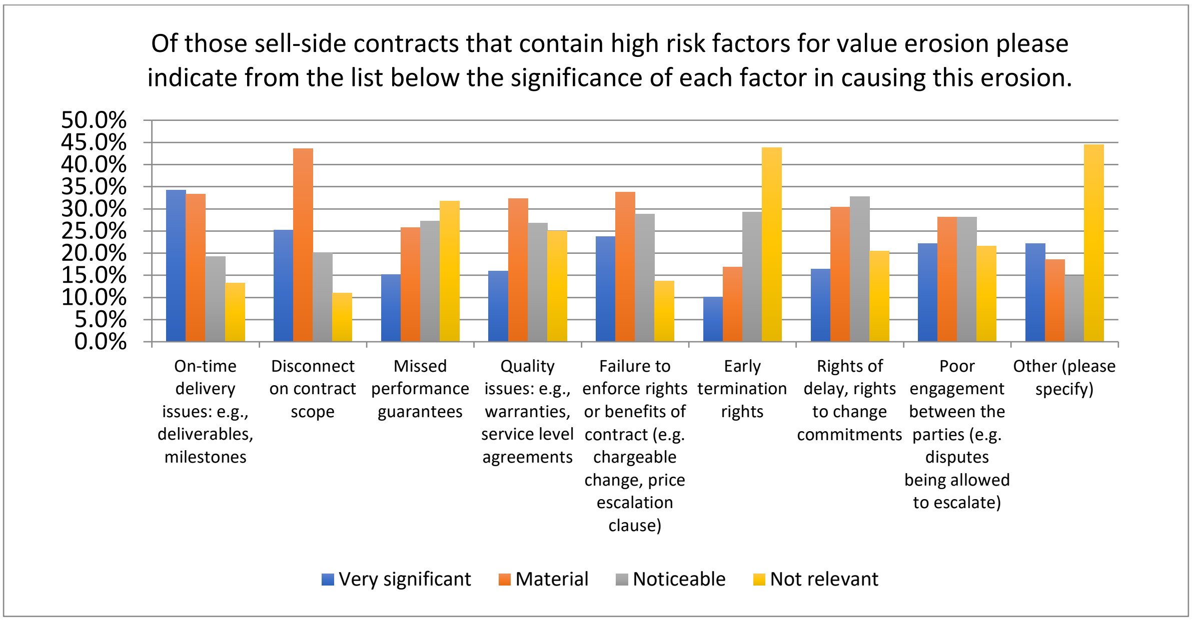

Chart 4: Supplier-based View of Risk Impact

For buyers (see Chart 5), a disconnect on contract scope is by far the most significant individual issue, but cumulatively it is the weaknesses in post-award governance and supplier management that generate the greatest value erosion. Enforcement issues are highlighted as material or very significant by more than 55%, with 'poor engagement between the parties' cited by 51%.

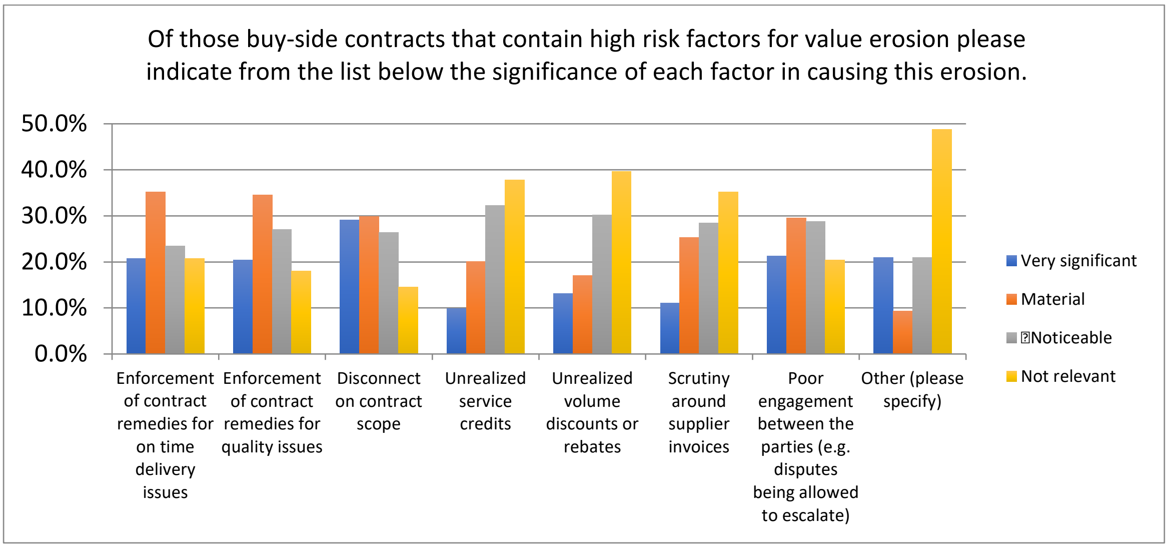

Chart 5: Buyer-based View of Risk Impact

This difference in the buyer-supplier perspective on how losses occur is important. It indicates the relative weakness of the buy-side resources allocated to post-award management. In most organizations, signed agreements move from Procurement to other parts of the business, where responsibility for performance is either undefined, or undertaken by individuals with limited training or support. Some 25% of buyer respondents indicate that their organization's post-award supplier management is 'terrible' or 'poor' – and this proportion is significantly higher in industries which have a higher ratio of complex contracts. This is detrimental to both parties; weaknesses in contract management result in disagreements and disputes, absorbing resources in activities that fight over allocation of the pie, rather than seeking ways that it might be expanded. However, it is also interesting to reflect on the earlier finding regarding the frequency with which suppliers over-commit. Perhaps part of the reason for over-commitment is belief that the customer will fail to hold the supplier to account. Indeed, in interviews, many buyers admit that their own failure to observe and follow the terms of the contract frequently weakens their position when trying to enforce the rights or obligations they inserted into the contract.

While there is no question that suppliers suffer from some level of value erosion[2], the survey findings (including the list of reasons cited in Chart 3 above) imply that the typical scale of loss is consistently higher among buyers. It is certainly the case that:

a) A much higher proportion of suppliers have invested in developing contract management skills and elevated this activity to a more professional level. Our benchmarks suggest that, in the case of higher risk contracts, the ratio of trained contract managers is approximately 4:1. Within buyer organizations, even where contract management is a defined activity, it is often viewed as purely administrative.
b) While suppliers unquestionably have some contracts that suffer from value erosion, there are others that benefit from value gain. Our data suggests that, for many, this has a balancing effect across the contract portfolio. Buyers are less likely to achieve this balance, especially since many of their more complicated, high value agreements are not supported by existing technology and there may not be a mechanism to collect and collate consolidated performance data. All they really know is that negotiated savings frequently do not reach the bottom line.

As subsequent sections of this report explain, the extent of losses varies substantially between industries and contract types. This is because levels of uncertainty and complexity are key drivers of value erosion and in that sense, not all transactions are equal and nor is the frequency of uncertain or complex contracts consistent across industries.

[2] 14% of sell-side respondents also rate post-award capabilities as terrible or poor.

Which contracts are most exposed?

In 2016, the Nobel prize for economics was awarded to Oliver Hart and Bengt Holmstrom for their contributions to contract theory. The press release announcing the award observed: "Modern economies are held together by innumerable contracts".

Clearly, many of these contracts are neither innately complex, nor of long duration. The extent of uncertainty and risk is therefore highly variable – and this includes the risk of value erosion (or potential for value gain). Our survey therefore sought input from contracting professionals on what types of agreement they consider have the greatest exposure to loss. For this purpose, we have excluded agreements that are potentially high risk, but for any single organization are relatively infrequent – for example, M&A, joint ventures and alliances.

Eight agreement or transaction types topped the list:

- Long-term services
- EPC/Construction
- Cloud/SaaS
- Outsourcing
- Sub-contracts
- Capital projects
- Facilities & Managed Services
- Consulting/Professional Services

This does not mean that every contract of this type leaks value, nor does it mean that other forms of contract or transaction type is loss-free. It simply implies that the listed items are more susceptible to loss and that this can be on a large scale. For example, a variety of studies have pointed to the scale of cost overruns on many capital projects, suggesting levels of around 60% in construction and more than 30% in oil and gas.[3] For megaprojects, the Cato Institute suggests an average of 50%, though a study for the European Commission proposed a figure nearer 80%.

Even simple commodity agreements are susceptible to value erosion if requirements are not well defined or delivery and quality are not well managed. But this is at a very different scale from contracts that involve multiple stakeholders and interfaces; where planning and delivery horizons are longer; where personnel changes are likely; where behavioral factors, such as optimism-bias or protectionism, will influence decisions; and where uncertain or unpredicted events will almost inevitably occur. When they are being designed, negotiated and drafted, very few agreements take account of factors such as these and consequently lack methods or mechanisms for their avoidance or resolution.

[3] See https://www.arcom.ac.uk/-docs/proceedings/4cbaa2ca1021ce2bc010658d11b15190.pdf and https://www.cato.org/policy-report/januaryfebruary-2017/megaprojects-over-budget-over-time-over-over

Which industries are most exposed?

Chart 6 shows the ten industries most susceptible to the issues addressed in this report. It reflects participant input regarding the proportion of revenue or spend that is subject to three or more high risk factors – for example, long-term, poorly defined specification, multiple obligations etc. Since this combination of factors is frequently associated with extensive disagreements, cost overruns and under-funded work which can cumulatively represent c. 30% of contract value, the extent of exposure indicated by this chart is clearly serious – especially for those industries where exposure is high on both sales and acquisition contracts. Hence, Engineering and Construction, Business Services, Telecoms and Oil and Gas all face potential value erosion on contracts totalling the equivalent of 40% or more of their annual revenue.[4]

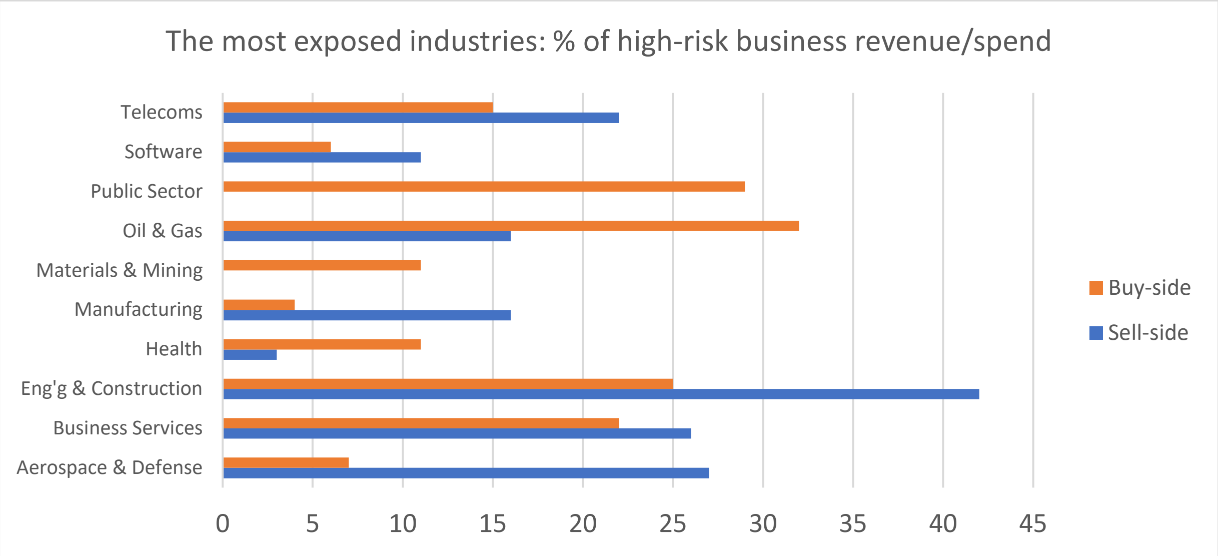

Chart 6: The top 'at risk' industries

Anecdotal evidence suggests that the scale of exposure is in fact higher than the percentages reflected in this chart. However, this will be validated through further research. It is also important to recognize that the situation varies within supply chains – for example, within Oil & Gas, the major producers do not typically have a significant volume of high-risk sales agreements, but that is not the case for their suppliers, performing on major programs and projects.

Being 'at risk' does not automatically translate to those risks being realized. One way of measuring this is to examine whether these high-risk industries have invested heavily in building their contract management competency. Charts 7 and 8 provide an answer, looking at survey participant ratings of effectiveness at managing and monitoring their contracts.

[4] Taking Oil & Gas as an example, 'risky contracts' cover 16% of sales revenue and 33% of spend. On average, the industry outsources c.70% of its work, so 32% of spend is equivalent to 23.1% of revenue, giving a total of 39.1%.

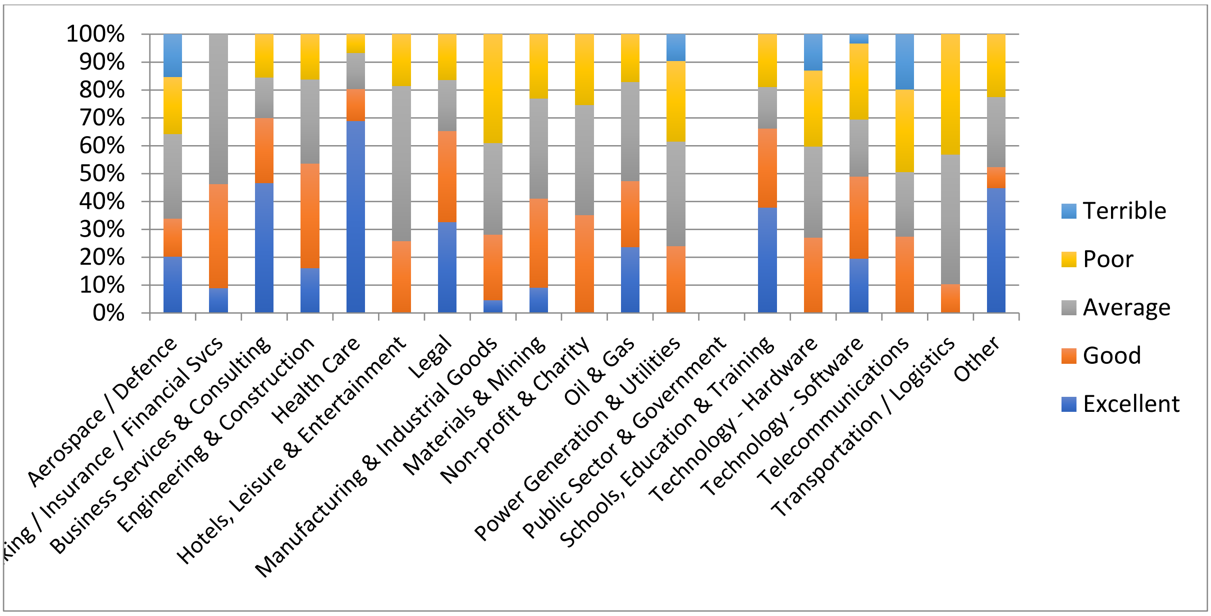

Chart 7: Rating of monitoring and managing sales agreements post-award

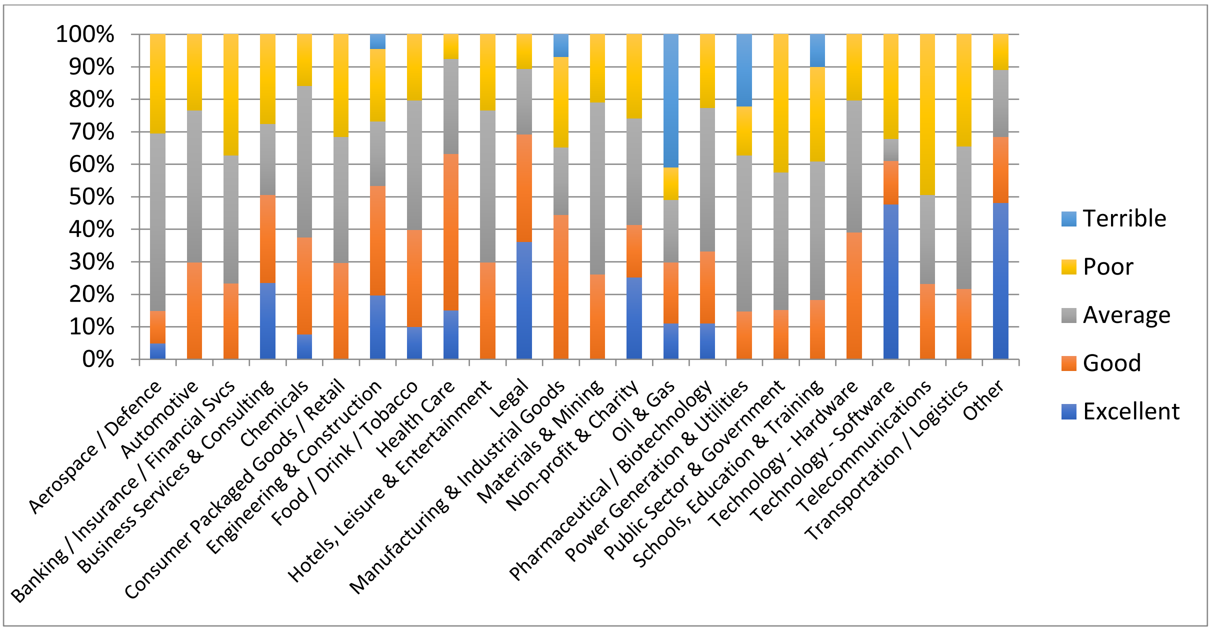

Chart 8: Rating of monitoring and managing supply contracts post-award

Conclusions

In many respects, this report represents the beginning of a story, not the end. It confirms persistent problems created by the fragmentation of process, systems and resources applied across the contracting lifecycle. Without connectivity, there is limited visibility and the absence of data translates to lack of urgency and lack of action.

There is also a view that, even when senior management is aware of possible value erosion, the problem seems too complicated to fix. The fragmentation that causes losses is so extensive that fixing it would require fundamental changes to business systems and operations.

Has the time now come when those problems can be addressed? There is a view that new technologies may prove game-changing, in that they offer the possibility of platforms that could aggregate and drive data flows between systems. They potentially augment human resources through artificial intelligence and machine learning, in ways that support simplification and promote self-service. New thinking about standards and contract design offer the prospect of increased market and business intelligence, for contracts to become tools that deliver operational efficiency.

This report shines a light on the types of contract and the industries where maximum benefits can be achieved. Realizing those benefits depends on evaluating and integrating the findings of other, related studies, such as the referenced work on Post-Award Contract Management; the Most Negotiated Terms report; studies on Relational Contracting; and recent papers on Supply Ecosystems, Friction Points and the use of Artificial Intelligence.

For many, the best starting point to evaluate current status and develop an improvement plan is to undertake a World Commerce & Contracting 'Capability Maturity Assessment'. This assessment (provided at no additional charge to Corporate Members) provides holistic process analysis and benchmarking to better understand and develop the business case for change and the likely benefits to be gained.

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