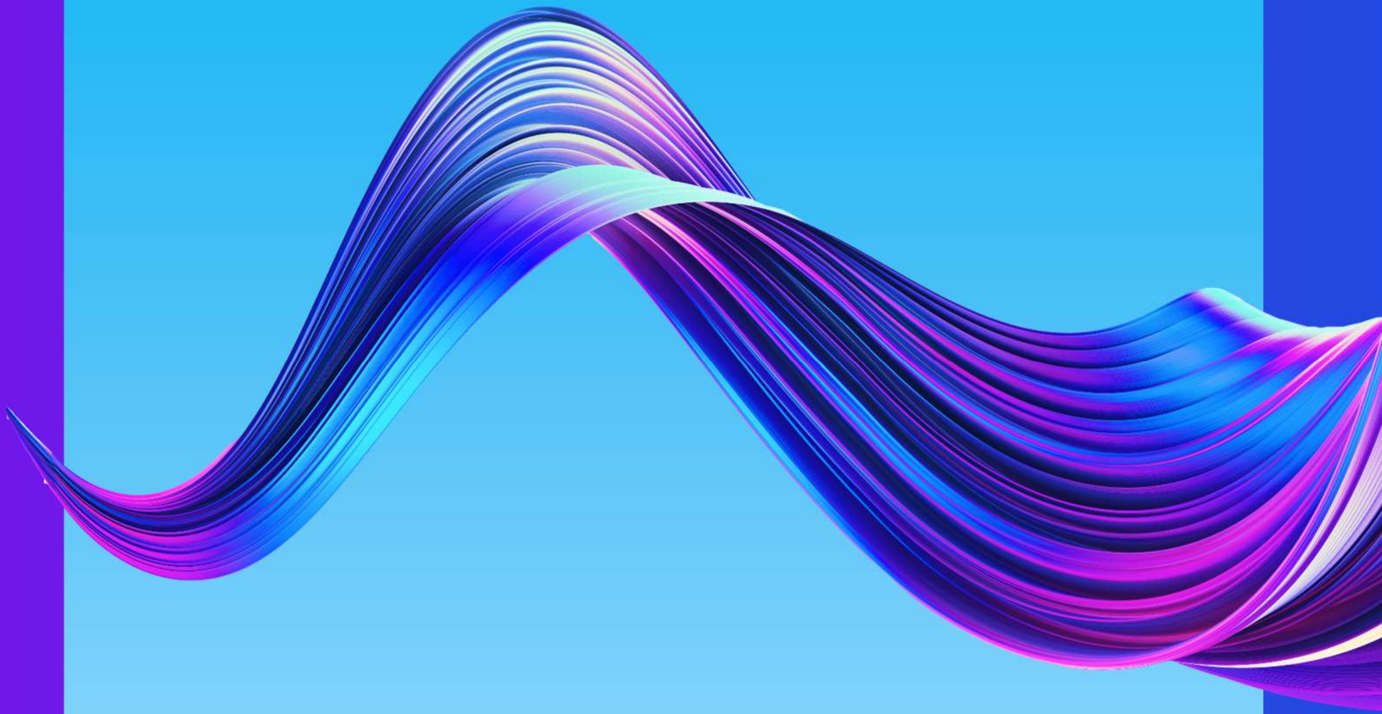

Unlocking Strategic Value

The Significance of Effective Contract Management

January 2024

Introduction

"Gamesa, like other manufacturers of wind turbines, has been hard hit by supply-chain disruptions, inflation, and a lack of components and raw material such as steel. This has raised costs which it cannot pass on to customers. Their contracts predate these inflationary trends, and do not include provisions to charge more."

Source: The Economist, 29th June 2023

"Governments are becoming more dirigiste, spurred by fragile supply chains in the pandemic, a more menacing China and the dangers of climate change. Company CEOs need a new approach for a new age."

Source: The Economist, 29th June 2023

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When procurement leaders, CFOs and supply chain stakeholders face issues dealing with complex contractual terms and conditions during the contract lifecycle, not surprisingly most will have to go through it with little or limited intel from agreed contractual terms and conditions that may no longer be valid due to several reasons, such as undocumented alterations throughout the process.

Procurement and other professionals dealing with the third parties will likely keep the status quo and business as usual without challenging current procedures and practices, people are too busy with their day-to-day activities and most of the time they have no visibility to even challenge a potential incorrect invoice logged in their system, approved for payment without further oversight and checks. A three way matching is not sufficient in this case.

For example, third party contracts will have complexities on how charges are passed on and treated – let's call **Company A** the service provider, and **Company B**, the client receiving the services from **Company A**.

The complex terms and conditions, such as the payroll spend from **Company A** for a specific group of professionals delivering services to **Company B:**

- **Company A** passes through their payroll spend or allocates a portion of the payroll spend to **Company B.**
- In addition to the payroll, **Company A** also categorises certain charges and accruals to **Company B**.
- **Payroll, Certain Charges** and **Accruals** are examples of complex charges passed from A to B.

The relationship diagram

Company A
Service provider

- Payroll
- Certain charges (as per agreement)
- Accruals

Company B
Your organisation

- Invoice (all in one place - payroll certain charges, accruals)
- Some kind of support documentation

Potential complexities faced when charges are investigated:

Payroll

Lack of visibility (e.g. any 'proportional' calculated amount, no explanation on variances).

Certain Charges

Charges doesn't appear to be supported by contract.

Generic descriptions

Accruals

Lack of visibility on the individual calculation.

Insurance charges are not as per terms of the contract.

Changing perceptions

Not surprisingly, someone would say that guidance on any complexity of the charges mentioned above should be followed by what is "defined in the agreement", or "as per the pricing schedule". The problem is, the agreement is usually not clear, or have a language that does not clarify how a particular charge should be treated, to name a few of the issues you may encounter.

In addition, decision makers will typically follow and take for granted the so called "good relationship" with their suppliers, and the "good practices" already in place. Typically, these "good practices" are not necessarily formally agreed, tested or validated – however prerogatives will usually prevail, such as "it's been in use for many years", so challenging stakeholders on any changes is usually off the table. This is a dangerous territory, a $5 million a year contract or even a lower spend contract could be easily classified as high-risk category after a comprehensive assessment.

Moreover, the lack of thorough controls in place to validate the charges (if any controls at all), and more importantly, the lack of a formal framework for a contract assessment (e.g., every 2 or 3 years during the contract lifecycle) to understand and identify the complexities in the agreements and what controls are or should be in place to mitigate the risks, comes with no surprise.

As a result, **Company A** may already have overcharged **Company B** over many consecutive months or even years in a variety of areas, including:

Benefits/potential recovery (% of spend)

3%	Miscalculation of the **payroll**.
1%	Misinterpretation of insurance **charges**.
2%	Lack of control on **accruals** (e.g., overstating a balance for a period of over 6 months, whilst contractual terms should only allow up to 6 months – or not surprisingly to discover there's no contractual clause in place) – we have seen accruals sitting on the balance sheet for a period of over 5 years and none of the parties challenged, costing millions in lost revenues to our client.

Artificial Intelligence models

More and more, all sorts of data points become accessible from different sources. The difficulty is to understand how to read the data to extract real value that will impact the bottom line.

Organisations typically lack time and resources to get things off the ground when it comes to complex programmes of assessing supplier's compliance and general understanding of what is going on behind the scenes after an Agreement is signed and operational.

Additionally, in most of the cases the data available to support such charges is unstructured, vast, and not directly connected to key terms and conditions of the Agreement. Organisations can't always keep up with changes and technology when it comes to compliance.

CCM ('Cognitive Contract Management') is an AI solution that can be tailored for such validations over Third-Party Agreements during the lifecycle of the Agreements and it is designed to deal with unstructured, vast and complex data sets to extract results that is important to you.

CCM is an in-house AI tool created by KPMG – unique in a way that the human element is always present, crafting the tool to enable pace and volume to significantly boost a compliance programme by automating the review and tests. The tool can be applied in a variety of industries and suppliers' Agreements to understand risks and identify commercial leakage in the organisation.

The benefits of being innovative by adopting CCM, equipped with the array of Contract Compliance professionals running the programme on your behalf ("The human element"), are countless, intangible when you improve the relationships with your supplier, protect your brand, your supply chain and reputation – tangible when you identify commercial leakage, recover lost revenues and direct impact the bottom line. All without having to disrupt the day to day activities in the organisation.

Ultimately, CCM will lead to improved controls and significantly reduce commercial leakage happening in the first place.

Some or all of the services described herein may not be permissible for KPMG audited entities and their affiliates or related entities.

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