With these tips, risk and performance management are two elements you no longer need to consider as threats.

BY ASHIF MAWJI

Reduce Risk, *Increase Performance*

Risks exist in virtually every contract. There are few organizations, however, that are able to manage these through a systematic, auditable, and regulated manner.

Sophisticated contract management (CM) software is able to scan contracts for elements of risk and performance and then track these items, report on them, and send alerts to all appropriate parties. This article will explore in detail the available functionality and various ways an organization can implement this incredible business-saving software.

Risks

Contract Language

There are several clauses within a contract that have various elements of risk associated with them. Typically, the deliverables section has a largest number of associated risks—both for the supplier and/or the customer. An example would be when a major computer chip manufacturer is buying a large majority of its silicon wafers from a supplier who makes 100 percent of its wafers in a plant that sits on a known fault-line in India. If a clause exists that indicates the supplier will provide 1 million silicon wafers per month upon a two-week notice from the customer, the obvious risks and questions are

(1) What are the odds of an earthquake occurring at the supplier's plant? If that were to occur, what would be the delay in getting a shipment?

(2) What if the supplier only has one plant and has no backup or contingency in place?

(3) What would be the time delay that is acceptable before the manufacturing delays caused by a missed shipment affect the customer's ability to meet their market demands?

These are just three of perhaps 30 risk elements that reside in this one clause.

Organizations need to assess risks and assign the probability factors of each element, as well as the impact in terms of money and time. Risks can have contributing factors, such as natural disasters and a raw goods shortage that should have probabilities assigned to them. Once a risk element has been thoroughly identified, appropriate workflow needs to be established to indicate at what percentage level notification e-mails need to be sent and to which parties. When the alert levels are escalated (e.g., green to yellow to red), determine clear steps to follow and what the material impact will be. (This is now necessary to report—per the Sarbanes-Oxley Act for publicly traded companies listed on the U.S. Stock Exchange.)

As you can see from the earlier explanation, the risk elements in a contract can have devastating effects

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on an organization if they are not assessed, tracked, or reported. By being proactive, organizations can often alleviate risks and resort to contingency plans when necessary. In the previous case, a contingent supplier would be part of the resolution process and would get the order if a specific risk element were escalated for the original supplier.

There are some CM software packages that have an elaborate risk management component that allow for scenarios such as the one discussed earlier to be reported, tracked, governed, and acted upon. Risk elements can exist at a contract, clause level, or supplier level. Risk elements can be tied to specific clauses, so when a clause is used in a contract, the associated risks are automatically attached to that contract. Whatever workflow and notification were tied to that risk will be automatically a part of the contract process.
It is important that risks be reported on just as accurately as in the contract's expiration phase.

Regulation and Management

Risk elements should be regulated within the organization, so those risks that are deemed material and significant can be automatically associated with suppliers, contract language, and even commodities (goods and/or services). Management should meet with the appropriate departments (sourcing, accounting, risk and audit, as well as legal) to brainstorm on all the risk elements that could have an unacceptable level of disruption. These need to be documented and assigned thresholds for notification (e.g., at what percentage level should a director be informed, a vice president notified, and a "C" level alerted). The departments responsible for creating contracts and templates should then ensure that the risks can automatically be associated when a new contract is created.

The facility to manage risk elements does exist in some sophisticated software. It is important to evaluate the CM software to ensure that these risk elements can be completely managed by the organization, and that it has the flexibility to add new risk elements, assign probabilities, and indicate risk cause potentials.

Most importantly, the organization should have the ability to indicate specific workflow and notification when a risk element reaches a certain threshold. Within the CM software, risks can be managed and reported based on impact on either monetary values or time (such as "time lost"). Some CM software also allows for tracking risk not only at the contract level, but also at the supplier level. This is also very important, as an organization would need to know what the risks and effects of a supplier's bankruptcy.

Performance Metrics

Indicating performance obligations in a contract is a standard procedure; monitoring and enforcing these standards, however, is quite rare. This is because when contracts are negotiated, all parties go through painstaking efforts to identify and negotiate performance terms and deliverables and ultimately sign off on these. However, once the contract is in place and commerce begins to take place, the management of the performance is a manual task and up to an individual or group to ensure compliance.

Identification

The first step within an organization is to identify key performance elements that should automatically be applied to different types of contracts, based on specific monetary range on a contract (if a contract is between $1 and $2 million, etc.), specific goods and/or services being acquired or sold (as in contracts, where purchased tires must have a performance metric which has a less than 1-percent defective rate), and so forth.

Once the performance metrics have been identified, the contract creation process needs to be modified to ensure that these metrics are a part of the executed contracts, and that all parties are aware of what the measures are, how often they will be reported on, and what the consequences are of non-compliance.

Fortunately, there are some CM software packages available today that do an excellent job of (1) allowing organizations to track performance obligations at a contract level, and then (2) helping organizations to associate specific workflow and notification tasks based on the outcome of a given metric (e.g., if the tire defective rates are between 1 and 2 percent, a penalty of 5 percent is applied to the last purchase order with the supplier). Performance metrics can be a healthy scorecard for both parties in a transaction, allowing the company customer to ensure it is receiving the best overall value from its suppliers. For the suppliers, the metrics give an opportunity to ensure that they are offering superior service to continue customer business.

Once metrics are assigned to contracts, organizations can run reports to demonstrate levels of performance on a specific commodity across all suppliers, indicating best and poor performers. Organizations can also look at performance metrics to improve their own internal processes and ensure streamlining to improve overall performance. CM software can allow organizations to run these types of reports with the ability to use on-line analytical processing (OLAP) functionality—in essence, showing the data in a graphical, highly detailed format.

Automated and Proactive Monitoring

Once you have indicated metrics, the next step is to ensure that performance levels are being actively monitored and executed. However, if you have tens of thousands of contracts, each one with 10 performance metrics, it is an unmanageable task to manually monitor these metrics.

Once again, CM software comes to the rescue! There are certain packages available that will allow organizations to basically take the “hands-off” approach. What this means is that organizations can indicate threshold levels on performance metrics—when the threshold is breached, a specific action can automatically be triggered by the CM software. For example, if a supplier fails on a particular metric, the software can automatically trigger an e-mail notification to the contract manager, the supplier, and possibly another stakeholder. This notification will serve as a notice of contract failure, and appropriate discussions and resolutions can follow. You can even go to the step of enacting automated discounts (penalties), based on failure to meet contracted levels of performance. These penalties can only be enforced if they were very clear in the contract, and if the performance failure is clearly the supplier’s fault.

CM software can also handle proactive management. When performance measures are following a trend (say, downward), specific notifications can be initiated to the affected stakeholders, allowing them to assess the situation and proactively manage a successful resolution or plan of attack.

By using the “hands-off” method, organizations can carry on doing business as usual and will only be alerted when the status quo is breached. This allows for a more efficient, effective use of resources.

Integration: Risk and Performance

Strategic sourcing is a common business process in many organizations. Typically, strategic sourcing is limited to reviewing pricing, or value, offered by suppliers across commodity or spend codes. However, a growing trend includes risk and performance track records as a key part of deciding which suppliers make the cut for being able to supply a specific product and/or service.

Organizations can now allocate scoring points to risk and performance elements, as well as pricing, vendor stability, and all the other good-value parameters. There are some CM software packages that will allow for reporting to include calculations that can derive scoring based on pricing, past-performance, and risks, as well as other criteria defined by the customer. This allows companies to run reports on a scheduled basis to show their top suppliers by category, so they can then decide if they want to limit any future buying to a list of accredited suppliers for a given commodity.

The End Result

With this impressive ability to manage risk and performance within the CM software, you will find very happy auditors, risk management, and sourcing professionals in your organization.

The task of managing risk and performance is a complex and time-consuming ordeal. If software can be deployed that will not only assist in the overall creation and management of contracts, but also automate risk and performance management, then the burden is less dramatic.

The workload can be relieved with automated management, and professionals in your organization can now focus on the strategic and forward-thinking elements of their jobs, allowing the organization to reap benefits in increased productivity and innovation. ***CM***