

Proudly presents...

# The risks and rewards of contract relationships

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# Discussion items

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- Context: The extended enterprise
- Identifying and managing contract risk
- Contract risk management methodology
- Construction cost assessments
- Case study examples of managing contract risks
- Closing thoughts

# Question #1

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Which of the below best describes your industry?

- 1.Consumer business
- 2.Energy and resources
- 3.Financial services
- 4.Manufacturing
- 5.Public sector
- 6.Real estate
- 7.Technology, media and telecommunications
- 8.Other

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# Context: the extended enterprise

## Question #2

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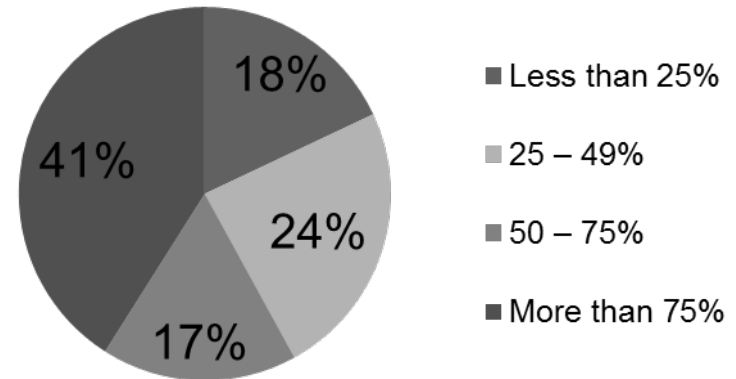
How important are external business relationships to your company's viability?

1. Extremely important
2. Somewhat important
3. Neutral
4. Somewhat indifferent
5. Extremely indifferent
6. Don't know/Not applicable

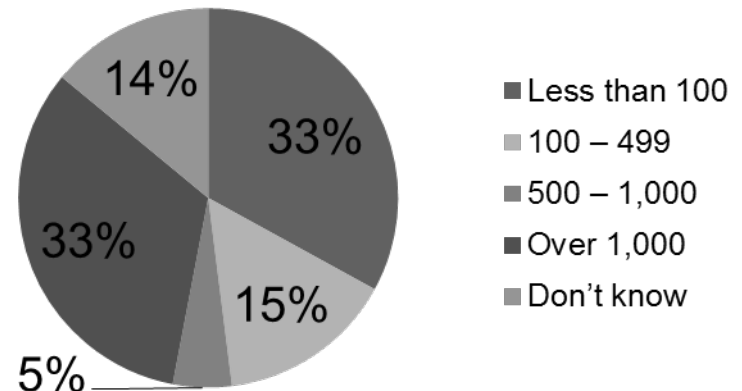
# Deloitte contract risk management survey

- 41% of respondents indicated that more than 75% of their revenue is derived from contractual relationships. As such, there is an increased interest in contract compliance programs.
- Most respondents anticipate an increase in the number of business partners in the future.

What percentage of your revenue noted is derived from contractual relationships with your business partners?

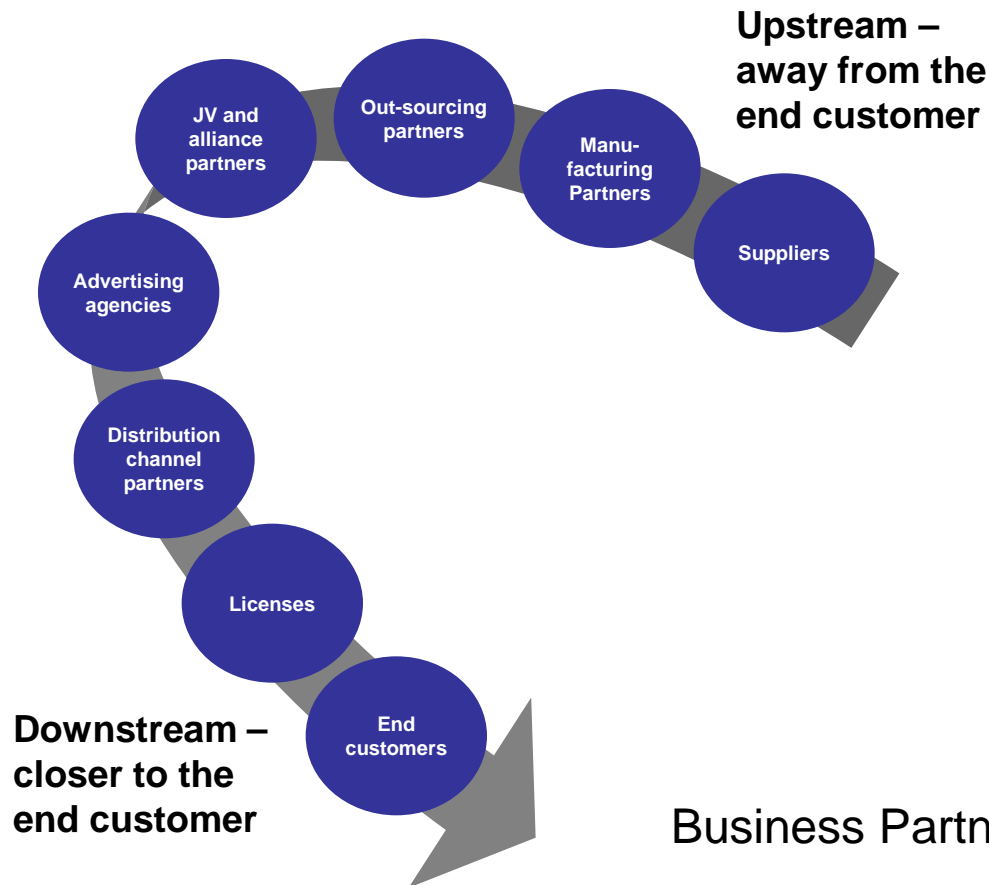


How many contractual relationships with business partners (for example, licensees, suppliers, distributors, agencies, etc.,) does your business unit have?



# The extended enterprise

Corporate growth and business success are increasingly supported through dependencies upon others, including outsourcing and licensing. These “external” or “extended” business relationships comprise what is now a widespread business model: the extended enterprise.



**The behavior of business partners across the value chain can significantly impact your:**

- Return on Investment
- Reputation & Brand
- Regulatory or Contractual Compliance

Business Partners along the value chain

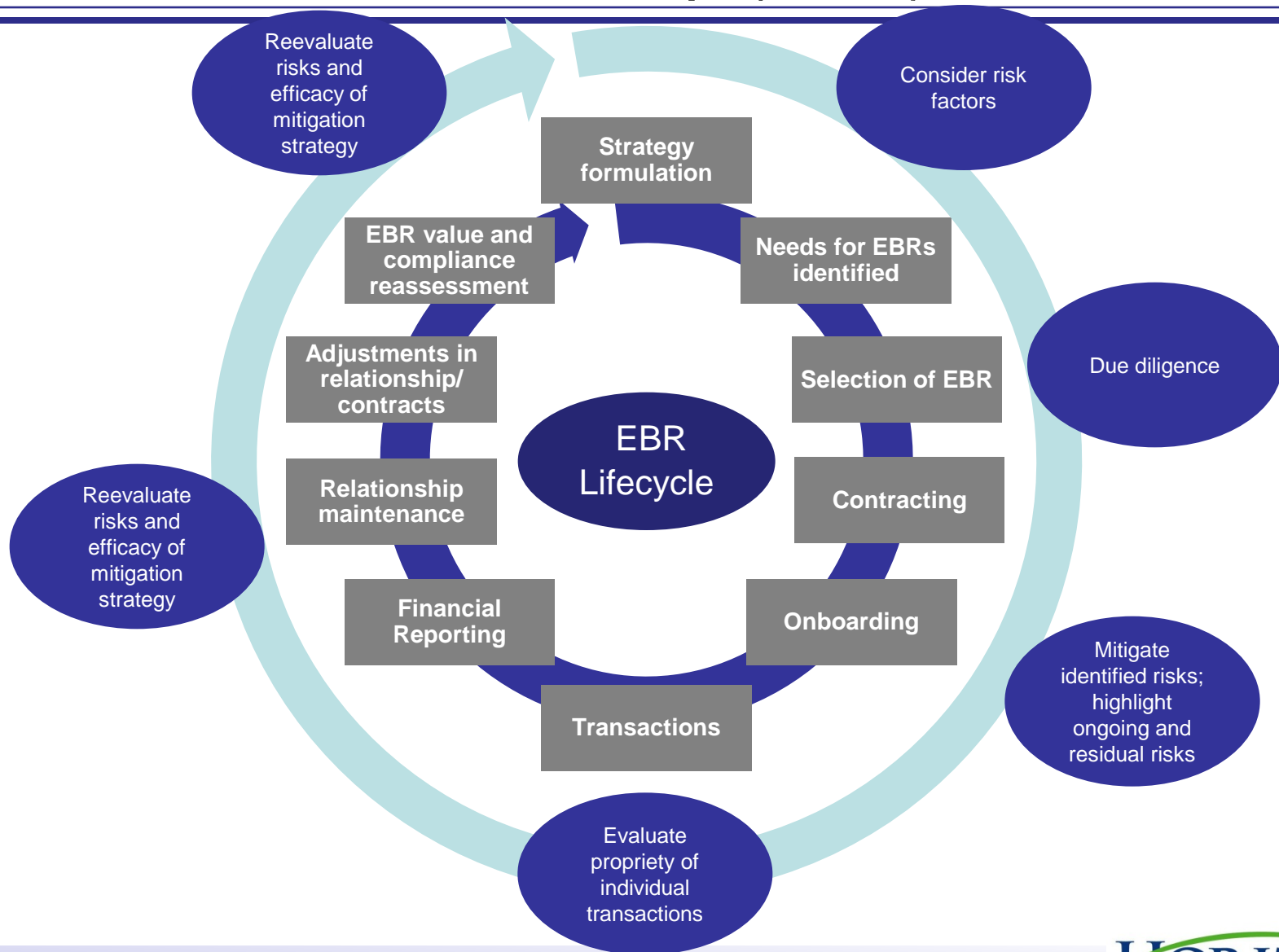
# Extended business relationships

- If companies neglect to identify and manage the risks, relationships may not only fail to capitalize the opportunities to create value, but they may jeopardize the entire viability of the enterprise.

Supply Side	Demand Side	Licenseses/ Intellectual Property	Infrastructure
<ul style="list-style-type: none"><li>• Suppliers</li><li>• Manufacturers</li><li>• Replicators</li><li>• Service providers</li><li>• Integrators and installers</li><li>• Warranty, maintenance and repair providers</li></ul>	<ul style="list-style-type: none"><li>• Franchisees</li><li>• Distributors</li><li>• Resellers</li><li>• Advertising agencies</li><li>• Retailers</li><li>• Fulfillment providers</li></ul>	<ul style="list-style-type: none"><li>• Licensees</li><li>• Original equipment manufacturers (OEMs)</li><li>• Co-brand partners</li><li>• Joint developers</li><li>• Intellectual property licensees</li></ul>	<ul style="list-style-type: none"><li>• IT outsourcing</li><li>• HR services</li><li>• Travel agencies</li><li>• Legal services</li><li>• Benefits providers</li><li>• Transaction processing</li></ul>



# Lifecycle of an external business relationship (EBR)



# Earning trust – A changing perspective

Common practices	
1.	Many companies require some level of reporting from their business partners.
2.	Historically, the approach of many companies is to “trust” the information reported by their contracted associates.
3.	Even in the most respected organizations, contracts, or elements thereof, can be misunderstood or ignored.
4.	It is not uncommon for some parties to do business without the benefit of clarity of expectations, or occasionally, sans a contract.

Is “Trust” the right approach?

# Question #3

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What level of confidence does your company have regarding the quality of information provided by your business relationship partners?

- 1.Strong confidence
- 2.Moderate confidence
- 3.Weak confidence
- 4.No confidence
- 5.Don't know/Not applicable

# Question #4

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What percentage of your contracts are subject to regular, effective monitoring?

- 1. None, 0%
- 2. Less than 25%
- 3. 25 – 75%
- 4. More than 75%
- 5. Don't know/Not applicable

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# Identifying and managing contract risk

# Identifying and managing contract risk

Contract risk management can be defined as an approach to understanding and mitigating the risks in extended business relationships.

Contract risk management approach	
Contract Risk Management helps <b>maximize the value and minimize the risk of the extended enterprise</b>	Determine if key partner risks are identified and addressed by your own internal control framework
	Verify whether your business partners are in compliance with their monetary and non-monetary contractual obligations

“Look in before you look out”: It is appropriate to ensure the organization is acting responsibly by adhering to its own commitments to its business partners.

# Counterparty risk – What companies increasingly are measuring and monitoring

## **Operational risk**

- Pricing decision errors
- Marketing program abuse
- Unintended discounting

## **Regulatory Risk**

- Fines for lack of compliance
- Required product recalls
- Cost of compliance

## **Legal Exposure**

- Litigation expense
- Business disruption

## **Financial Exposure**

- Revenue Leakage
- Excess costs
- Remediation expenses

## **Supply/Sales Risk**

- Supply disruption from supplier bankruptcy, performance issues
- Sales disruption from customer financial, performance issues

## **Contract Non-Compliance**

- Leakage of supplier/customer contract pricing
- Lack of adherence to SLAs
- Financial exposure
- Security exposure

## **Regional dysfunction**

- Geography and culture governance misinterpretation
- Lack of transparency

## **Brand/Reputational Risk**

- Brand damage
- Voluntary product recalls
- Audit expense

## **Intellectual Property Risk**

- Under-reported use of IP
- Loss of IP to suppliers/business partners
- Inadequate protection of IP on the part of suppliers/business partners

**Potential Impact  
of Business  
Relationship  
Drivers**

# Question #5

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Which type of contractual relationships are most concerning to your company?

1. Intellectual property
2. Services/vendors
3. Software
4. Outsourcing/offshoring
5. Other
6. Don't know/Not applicable

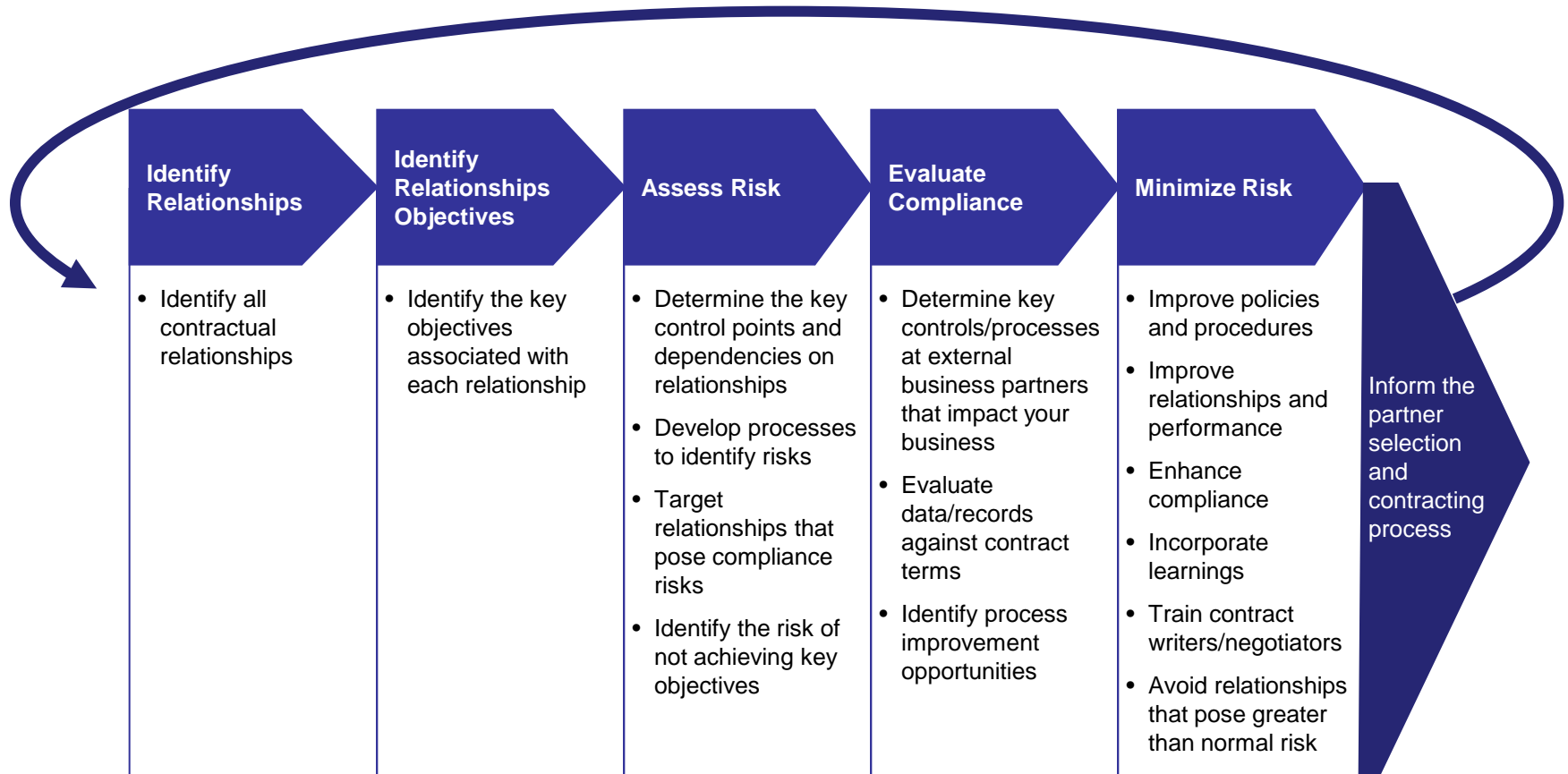


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# Contract risk management methodology

# Contract risk management methodology

Organizational contract risk management processes reinforce the program



# Contract risk management in practice

## Example A: Manufacturing lifecycle

### Product design:

- Joint development agreement inspections

### Product manufacturing:

- Supplier inventory inspections
- Most favored pricing inspections

### Licensing:

- Royalty inspections

### Product sales:

- Distributor inspections
- Advertising inspections
- Market development fund inspections
- Franchise inspections

### Product support:

- Call center inspections
- Service provider inspections
- Warranty services inspections

## Example B: Software lifecycle

### Product design:

- Joint development agreement reviews

### Product production:

- Authorized replicator inspections
- Production and EOL scrap mgmt

### Product integration:

- OEM royalty inspections
- Third-party installer inspections

### Product distribution:

- Distribution inspections
- Reseller inspections
- Large account reseller inspections

### Product usage:

- End user license inspections
- License purchase analysis

# Question #6

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Has your organization performed a vendor related contract inspection or exercised its right to audit clause before?

1. Yes, more than once a year
2. Yes, but less than once a year
3. Never
4. Don't know/Not applicable

# Challenges in deploying a contract risk methodology

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- **Resources**

- Limited funding
- Limited resources
- Prioritization

- **Internal impediments**

- Managing the business during difficult times
- Leadership support
- Siloing of touch points
- How much is enough

- **Information**

- Diverse systems, many paper
- Limited transparency
- Availability of nonpublic information
- Incomplete data
- Access to relevant data for decision making

- **Resistance from markets/BPs**

# Addressing program challenges

Although many companies are aware of the need for effective CRC activities, some are initially hesitant to initiate or contract for CRC programs because of the following:

## Potential concern

## Consideration

**Apprehension over potentially harming the relationship**



- Insulation-often why an external party is engaged
- Clear communication of program objectives
- Conduct inspections in transparent manner
- Each subject is treated as prospective client.

**Cost of the CRC program**



- Significant return on investment for CRC fees is common
- Many contracts permit passing audit costs to the other party

**Lack of audit clause in the contract to allow a compliance review**

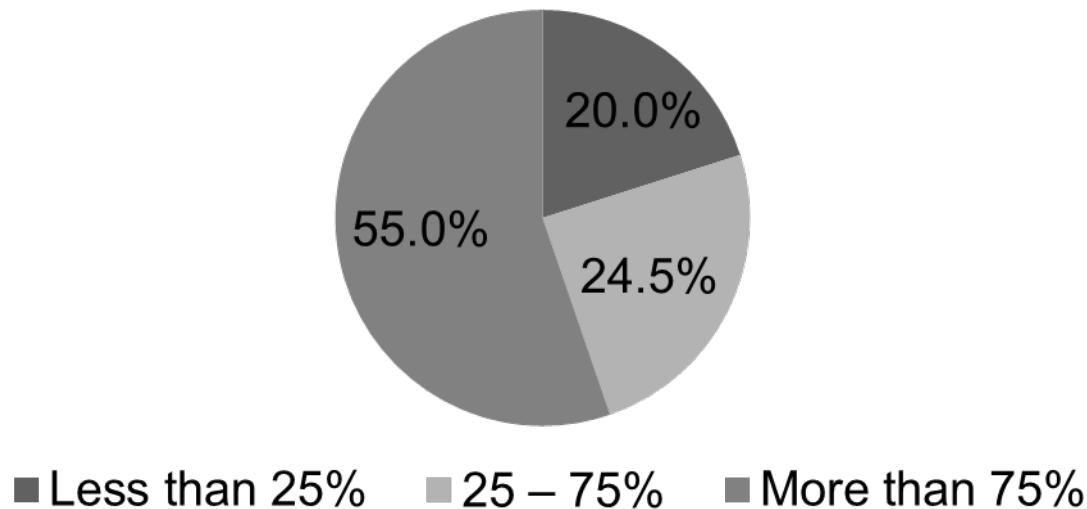


- Some activities may be performed without an audit clause in place
- Audit rights may be present in operations guides or other material

# Contract risk survey findings

Many companies do not associate contract compliance with positive dividends, when in fact, positive ROI is quite common for CRC programs

**Deloitte Survey Results: Relative to compliance budget, what percentage do you typically recover through collections?**




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# Case study examples of managing contract risks



# Case study #1: The mystery of the missing income?

Challenge	A Party of a joint venture ("Company X") noticed that their share of income being reported by the Joint Venture did not add up.	
Situation	After recently joining a Joint Venture with a online comparison shopping service, Company X noticed an increasing variance in expected revenue that what was being reported. In addition, there was very limited vision into revenue being reported. The relationship was strong with the Partner who was trusted, but the gap was something that couldn't be ignored.	
Solution	Company X exercised their right to audit and performed a financial reporting process assessment at the online shopping service to confirm if controls were in place over reporting joint venture revenue. Further investigation identified that the there was a significant difference in understanding of how revenue was determined from both sides and interpretation varied greatly.	
Outcome	The process was executed in a professional manner, differences in understanding were identified for clarification, and in fact the relationship between both parties actually improved due to increased communication, dialogue and resolution of the matter.	

But  $2+2 \neq 3$ , what happened?

# Case study #2: Vendor performance

<b>Challenge</b>	Vendor invoicing identified as a risk.
<b>Situation</b>	Company's' spend millions through outsourcing services, yet such contracts are complex, numerous, can be vague, misinterpreted, or inadequately monitored. Erroneous contractor charges not in compliance with the contract (e.g., labor charges, material charges, overhead allocations), Duplicate charges (e.g., material charges, labor charges, billing of both per diem/• meal allowance), Excessive contractor time charges • Inadequate monitoring of contractor charges. Are easy to make and go unnoticed.
<b>Solution</b>	A repeatable process was developed to audit vendor invoices. This process was automated using data analytics which provided efficiency and breath of coverage which wouldn't be feasible if done manually. In addition gaps in the invoice monitoring process were identified.
<b>Outcome</b>	Internal Audit was able to efficiently identify potential recoveries of \$9.4 million in overcharges, representing a potential recovery of 4.41% of the \$212.9 million in total spend on the contracts. In addition, the analysis resulted in ongoing monitoring of charges on a more current basis as well as process improvements.

## Example potential recoveries:

Partial excerpt of the potential cost recoveries from the case study. Construction vendor total contract spend \$77,000,000.

Potential recovery area	Potential recovery finding	Potential recovery amount
Labor	Work time charged more than 14 hours/day	\$196,000
Labor	Duplicate labor time entry	240,000
Labor	Incorrect overtime charges	156,120
Expense	Duplicate expense invoices	430,250
Materials	Duplicate material invoices	1,895,000
Labor	Invalid per diem	780,000
Labor	Invalid union charges	1,760,000
Labor	Incorrect per diem	120,000
Labor	Incorrect union charges	160,600
Totals		\$5,737,970
	% Potential recovery vs. spend	7.45%

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# Closing thoughts

# Questions to consider

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- How is management identifying, measuring and monitoring our key relationships, extended ventures, and business relationships?
- How do we validate the trust we are placing in others?
- Are we paying fairly for contracted services or raw materials?
- Are we receiving appropriate revenue?
- Is the quality of our products meeting our standards?
- Are our products, data or intellectual property being distributed to or accessible by unauthorized parties?
- If our EBRs fail to comply with our expectations, how would our brand be affected? How would our business relationship be affected?
- Could our market competitiveness and customer satisfaction be harmed by non-compliant business relationships?
- Is there clarity regarding who in the organization has responsibility for the different risks which result from doing business with others?

In short: “Trust but Verify”

# For more information

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If you would like more information about contract relationships or how Deloitte can help your organization, please contact:

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