E-BOOK:

Five Best Practices for Renegotiating Supplier Contracts

PRGX

Contents

Five best practices for renegotiating supplier contracts

Complexity creates risk, and risk can impact profits. Written contracts help businesses manage costs and minimize exposure to price fluctuations, but even when agreements are in place, the wording can be interpreted differently or simply not adhered to.

Companies assume that having a contract with a supplier means they'll automatically receive all negotiated benefits. But errors, misunderstandings, and inadequate oversight of agreed terms mean suppliers don't always deliver everything outlined in the contract. Hidden inefficiencies and un-realized advantages are very much the norm.

Given the time and resources procurement teams devote to sourcing and negotiating with vendors, it's best practice to make sure their contracts deliver all promised value across the term.

But ensuring that every supplier is in full compliance with its contract requires years of experience and a focused data-driven approach: one that can reveal business insights, optimize procurement and accounts payable processes, and even recover some of the losses caused when suppliers don't stick to terms. Implementing contract compliance measures will better lock in the value that's been negotiated across your supply chain by adding controls and transparency. Together, those can lead to improved long-term vendor relationships – something that can be hugely beneficial to your business.

Contract renegotiation offers a unique opportunity to engage he process. By triggering essential conversations about the future relationship, measures to ensure compliance with agreed terms can be embedded in purchaser and supplier invoicing processes.

This e-book will outline why supplier contracts don't always deliver the value expected, the supplier relationship and financial benefits of getting the contract negotiations right, and five best practices when renegotiating a contract.

Supplier contracts don't always deliver full value

In the push for growth, companies find themselves dealing with an increased volume of contracts. It's a good problem to have – until it becomes a real problem.

In large organizations, suppliers deliver everything from office supplies to consulting services, and issue thousands – sometimes millions – of invoices each month. Then they need to consider organizational complexity, a multitude of ERP systems, and volumes of transactional data both internally and from the supplier. Within that hailstorm of payments and disbursements are mistakes that undermine the savings detailed in the underlying supplier contract.

The reasons for overpayments range from simple error to outright fraud.

The latter occurs rarely, but even small instances of human error – typos, erroneous tax calculations, and duplicate payments – can quickly add up to large losses.

Poor contract compliance has a real bottom-line impact. Research from Ardent Partners has shown that noncompliant spend on suppliers can add an extra cost of between 12% and 18% for the average enterprise[1].

To reduce the risk of losses, organizations must improve management of supplier contracts and institute controls to help stop leakage before it happens.

[1]Ardent Partners: Beyond Recovery: Unlocking the Full Value of your Contract Compliance Program

Ways problems can manifest

Some overpayments can be remedied painlessly, but others have the potential to balloon into something more serious.

Perhaps you have a long-standing contract with a materials supplier where pricing hasn't been updated in recent years. This could lead to products or components being sourced off-contract on an ad-hoc basis, leaving too much scope for costly mark-ups.

Another issue can arise when outside contractors are being sourced through agencies. If the pay bands for roles, projects, and deliverables aren't carefully prescribed, agencies may move the same people up and down the bands without prior discussion about suitability, or have the same people working on multiple projects concurrently, again at different pay bands.

There can be perfectly legitimate reasons why this occurs. Still, in a complex staffing agreement covering a broad remit or multiple countries, there is enormous potential for error, such as inappropriately defining roles to maximize billings.

Benefits of getting it right

To minimize loss from overpayments, companies can undertake recovery audits and recoup much of what's been lost to mistakes, misunderstandings, or in the worst case – fraud. Cumulatively, this can equate to hundreds of thousands and or even millions of dollars.

But recovery audits are necessarily retrospective and reactive. Rather than stopping the source of a leak, they gather up the drips – often years after the fact. There are costs associated with that, plus time and effort, and relying on them to recoup loss could be risky, mainly if the target is a strategic, high-value vendor relationship that could be damaged by frequent requests to return money.

The better option is to implement a contract compliance program with a preventative approach that looks for process and value improvement across the full source-to-pay spectrum for the suppliers you specify.

If you set a best-practice framework and apply the insights and learnings post audit to the entire supplier contract lifecycle, this can limit or even prevent the issues that cause overpayment in the first place.

The mechanisms to achieve that include standardized contract language, a centralized repository of approved contract templates, and systems that make contract search, discovery, and review easy to execute.

Benefits of a contract compliance program:

- Improve visibility into existing contracts
- Drive greater on-contract (i.e. compliant) spend
- Increase supplier-side contract compliance and adherence to SLAs
- Reduce savings leakage

Improving vendor relationships

A better process and the implementation of accounts payable controls can help ensure that a supplier's performance obligations are tracked and managed. Using payment terms as an example, while most invoices have due dates and agreed penalties for late payments, it is not uncommon for companies to fail to catch them.

Businesses also frequently find themselves unwittingly paying too much for goods and services because they haven't kept track of volume or other discounts built into the vendor contract.

Adequate controls and processes as part of an ongoing contract compliance program can minimize these issues or eliminate them altogether.

Contract renegotiation is the ideal time to improve process

Whether a contract is approaching the natural end of its agreed term, or you've decided to call time on a contract that has been extended or allowed to renew automatically, contract renegotiation offers a unique opportunity for a reset.

First and foremost, both parties will enter the discussion in the right frame of mind, knowing there will be an open conversation about what's worked and what hasn't. A renegotiation gives you trading and operational history to draw from that can inform how the new contract should be structured.

Alongside necessary updates to pricing, clauses, service level agreements (SLAs), discounts, rebates and other terms, the door will be open to discuss invoicing issues, process improvements, and how both parties can work more effectively to meet their business objectives.

As a purchasing organization, you can also prepare for renegotiation by conducting a contract compliance audit. That will allow you to bring evidence to the table of overpayments and their causes – making your arguments for changes more persuasive.

1

Get the language right

Crafting a contract's language and communicating the key terms to all stakeholders on both sides can reduce supplier payment errors caused by confusing or unclear wording.

Ambiguous contract language around tiered pricing, for example, could create a mismatch in expectations and payments, causing loss due to overpayments or discrepancies in delivery. By establishing clarity and consistency in contract language, procurement teams can make permanent fixes that improve existing contracts and minimize future issues.

Ideally, contracts will use clear and straightforward language that limits the opportunity for interpretation. Contracts should also have a comprehensive audit rights clause covering access to relevant financials and data.

Both parties should understand clearly what is and is not included in the contract. Activities to be undertaken by suppliers are an important part of this. These need to be captured in order to minimize any practices that do not comply with the terms of the contract, like additional component sourcing or sub-contracting.

2

Make sure both parties understand and acknowledge the commercial terms

Contracts also need to capture the intent of the parties. That means ensuring that the primary mechanics of the contract are clear and consistent, including mark-ups, pass-through costs, expected margin, lump sum, and time and materials.

Any rebates, volumes, discounts, and other allowances should be considered.

For data compliance and auditing purposes, contracts should cover data retention requirements.

3

Ensure accountability and responsibility

Using renegotiation to improve supplier relationships also means making sure both sides in the contract understand their obligations.

You (the purchasing organization) should be in control of the contract document. It's yours. You own it and should ensure that any variations to it are documented and recorded.

Copies should be held centrally in a secure environment along with any attached scopes of work, agreed variations, contract addendums, and supporting documentation.

All stakeholders at your and the vendor's organization should be aware of the contract's terms and conditions, and they should acknowledge they bear responsibility for compliance with the contract.

Ultimately it is the supplier's responsibility to make sure they charge in line with the contract, and they should be fully aware of this expectation within the contract relationship.

4

Embed strong governance in the contract and the relationship

When a supplier provides services or materials that are critical to your business, it makes sense to undertake regular reviews to ensure the contract and relationship are operating as expected. The review can highlight any issues, and point to SLAs and key performance indicators (KPIs) at contract renegotiation that can better govern and measure performance.

If there are any gaps between wording and application of the contract in 'the real world,' these need to be surfaced and discussed openly.

Both sides should be able to discuss if the benefits captured in the contract are being realized as expected.

Having risk mitigation and control language along with a 'what happens if something goes wrong' clause are all necessary elements. They put the onus (and cost) upon the supplier for putting any errors right.

5

Structure the supplier relationship correctly

Strategic and sensitive supplier relationships require investment, including regular communication, reviews, and reconciliations on a predictable schedule during the contract lifecycle.

Remember that while operations may own the relationship, in many cases procurement owns the contract. Stakeholders from both areas need to be involved in renegotiations.

It's also worth noting that no matter how aggressively you've negotiated a contract, suppliers still need to make a profit. If the contract is unbalanced, it increases the risk that a supplier might try and extend margins with hidden charges, and use any ambiguity in language to their advantage.

Summary

Contracts are the tie that binds organizations to their supply chains. They should deliver the value procurement teams negotiated at the outset, and the specific terms agreed by the parties.

But without visibility and control, businesses expose themselves to savings leakage and overpayments. For businesses looking to increase savings wherever they can, implementing a contract compliance program is critical to success.

Contract renegotiation offers a perfect opportunity to start the process. By incentivizing greater on-contract spend, reducing risk, and improving supplier relationships, organizations can preserve the value procurement teams have worked so hard to secure.

About PRGX

PRGX helps companies spot value in their source-to-pay processes that traditional approaches simply can't. Having identified more than 300 common points of leakage, we help companies dig deeper and act faster to get more out of their recovery audits.

We pioneered the industry 50 years ago, and today we help clients in more than 30 countries take back US$1.2 billion in annual cash flow each year.

It's why 75% of top global retailers and a third of the largest companies in the Fortune 500 rely on us.

For more information, please visit

www.prgx.com

PRGX

marketing@prgx.com ◆ prgx.com