

Contract Management *Can* Improve Corporate Governance

Corporate boards and leadership need to regain trust by demonstrating commitment to higher standards of accountability and adherence to provisions of the Sarbanes-Oxley Act.

BY GOPI KALLAYIL

The business press has been dominated by recent waves of corporate scandals, and several well-respected companies have had to dramatically restate their earnings. It's not surprising, then, that a poll of corporate executives taken by Kennedy Information, publisher of *Shareholder Value* magazine, found that 46 percent said these scandals have harmed the way investors viewed their companies.¹ "Investors increasingly demand full transparency of accounting policies and their effects,"² the Securities Exchange Commission (SEC) noted in a "guidance" that detailed its expectations for annual reports.

In July 2002, legislators passed the Sarbanes-Oxley Act to help reestablish trust in corporations. The most sweeping change in corporate governance since the Great Depression, the Sarbanes-Oxley Act is designed to prevent corporate and accounting fraud by increasing the transparency of corporate finances, policies, and practices.

About the Author

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U.S. President George W. Bush shakes hands with co-sponsors U.S. Senator Paul Sarbanes (D-MD) (R) and Rep. Mike Oxley (R-OH) of the Sarbanes-Oxley Act of 2002, at a ceremony in the East Room of the White House, July 30, 2002. The legislation improves the quality and transparency in financial reporting and independent audits and accounting services for public companies.

The Sarbanes-Oxley Act mandates that corporations develop sound internal controls, as well as provide timely and accurate disclosure of financial information to investors. The act also specifies oversight and penalties to enable enforcement of these requirements. While most corporations focus on aspects of the Sarbanes-Oxley Act that govern financial transactions, the act also has implications for the commercial contracts that underlie each financial transaction. This is an area that most companies today are ill-prepared to manage. Contract management software has emerged as a powerful solution, providing organizations with greater visibility into contracts and enabling the control and disclosure necessary to comply with the requirements of the Sarbanes-Oxley Act.

Improving Corporate Governance

Good contract management is critical for enabling corporations to fully comply with several key Sarbanes-Oxley Act provisions including certification requirements, rules requiring enhanced

internal controls, and disclosure mandates.

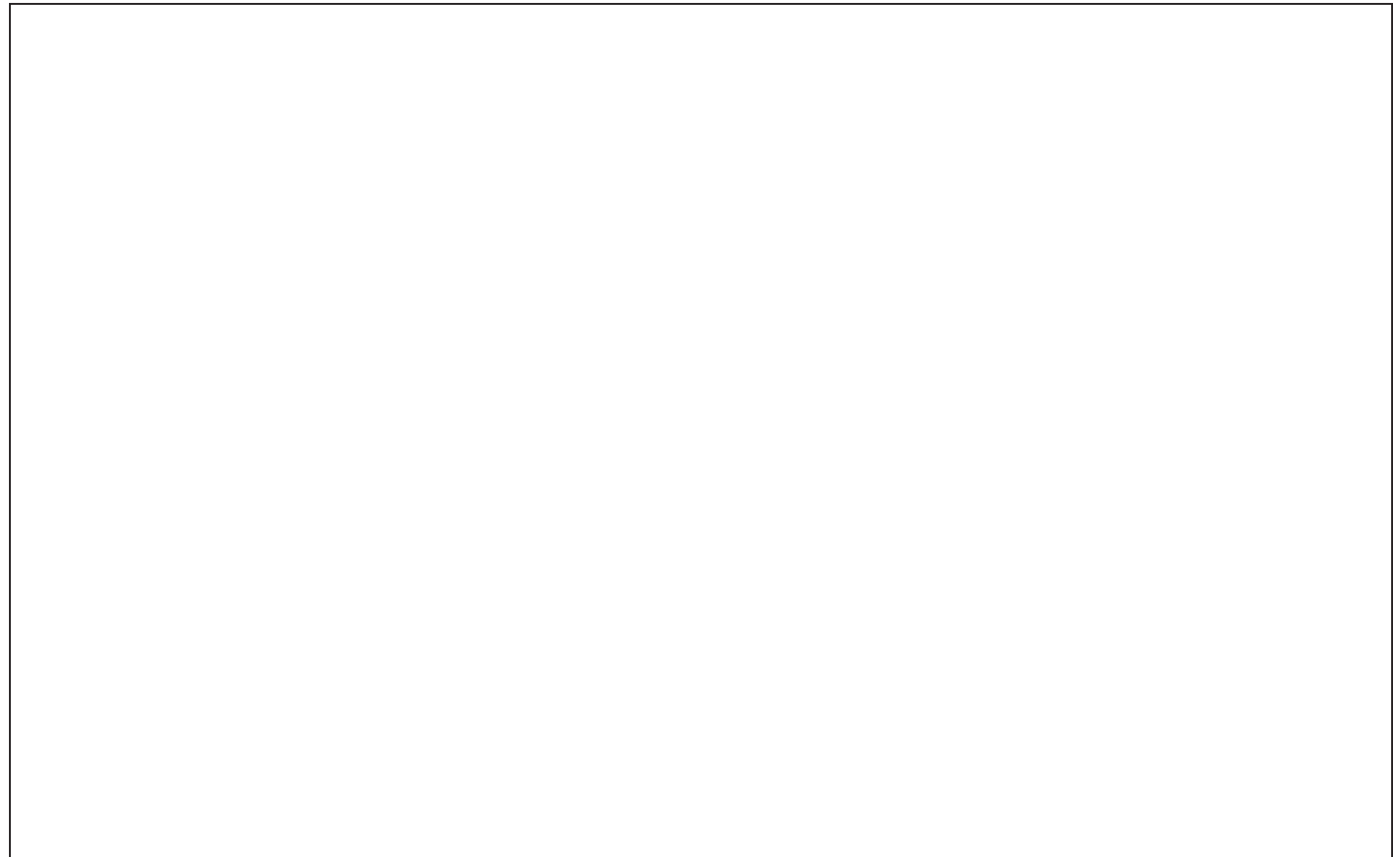
The Sarbanes-Oxley Act's certification requirements place tremendous responsibility on CEOs and CFOs to guarantee the accuracy and reliability of all financial information in their 10K and annual reports. The financial information that appears in these reports is a snapshot of what actually happened in the previous financial period. This, in turn, is often driven by a set of underlying contracts that detail what should have happened.

Consider the example of a software company signing a complex five-year agreement comprised of licensing, professional services, maintenance, and training fees. The contract may have several milestones linked to service delivery that determine when revenue can be recognized. The contract may state that the customer pay for professional services when the contract is signed. Yet, according to generally accepted accounting principles (GAAP), the company may only be able to recognize the revenues in the

quarters when the services are actually delivered. The financial statements certified by the CEO must accurately reflect these contractual complexities.

The Sarbanes-Oxley Act also states that corporate officers must design and evaluate internal controls to ensure the accuracy of any information linked to the financial condition of the company and of the company's financial results. To comply with this portion of the act, corporations must put in place good internal controls to guarantee that contracts are written and managed according to tight internal standards. Any exceptions to these standards must go through appropriate reviews and approvals, and an audit trail must be maintained.

Finally, the act mandates enhanced disclosure to ensure that stakeholders have adequate visibility into financial dealings within the company. This means that companies must disclose the details of contractual relationships with various entities. According to the SEC guidance, regulators could consider "even a technically accurate



Key Sections of the Sarbanes-Oxley Act

Section 302	Principal officers must certify that they have reviewed the financial reports, that the reports do not contain any untrue statements, and that the reports fairly present the financial condition and results of operations. The signing officers must also certify that they are responsible for establishing and maintaining internal controls.
Section 404	Companies are required to prepare an internal control report that includes management's assessment of the effectiveness of internal controls.
Section 409	Companies are required to disclose to the public on a "rapid and current basis," material changes to their financial condition.
Section 906	Principal officers must certify that periodic reports comply with the Securities Exchange Act and the information fairly presents the financial condition and results of operations of the firm.

as members of contract management industry associations seeking to promote industry best practices and the development of the contract management profession. Key findings included the following.

Contract Creation and Accessibility

To meet the requirements of the Sarbanes-Oxley Act for good internal controls, companies need good automated workflows to standardize the contract development and review processes and minimize inconsistencies. Audit trails are necessary to track how modifications to standard contracts were reviewed and approved. Yet, few companies have implemented such automated workflows. Because paper-based contract systems are still the most prevalent form of contract management, large, geographically distributed organizations have a difficult time accessing their contracts. More than 80 percent of respondents said that simply finding their contracts was an area of concern, and most said they would be unable to locate up to 10 percent of their contracts.

Contract Risk

Signing a contract always creates some risk exposure to any company, since contracts entail commitments and obligations. Yet, 26 percent of the companies surveyed do not use pre-approved templates for creating contracts that contain standard language designed to minimize risk. And, when new language is added to the contract—which can potentially increase risk—34 percent of the companies surveyed have no formal risk-evaluation process before the contract is signed. As a result, 71 percent of the companies surveyed said contractual risk is a major area of concern. The Sarbanes-Oxley Act also requires companies to accurately disclose these contractual risks to their boards and investors. Yet, three out of four companies did not have a reliable system in place to alert key parties when a contractual risk was triggered.

application of generally accepted accounting principals" misleading if it failed "to communicate important information," such as potential risks of off-balance sheet debt, arrangements, contingent obligations, and relationships with unconsolidated entities. To make adequate disclosures, companies need to be able to easily access specific terms and conditions and track risks contained in their contracts.

Contract Management Today

The vast majority of companies today, however, do not have the desired level of control over their contracts, according to a comprehensive and extensive survey on industry challenges and best practices in contract management conducted by Nextance. The survey consisted of interviews with C-level executives and managers at more than 150 Global 2000 corporations, as well



Revenue and Cost

More than half of the companies said they were unable to analyze their contracts by vendor or customer, limiting their ability to optimize contract performance. More than 40 percent said they could realize large incremental revenues and cost savings through better contract management.

Overall, the survey revealed that the vast majority of companies do not have the desired level of control over any of the four key areas of the contract life cycle:

- (1) creating contracts,
- (2) gaining visibility and access,
- (3) managing commitments, and
- (4) tracking contractual risk.

Without internal control, companies are unable to provide stakeholders and audit committees with adequate visibility into complex contracts and contractual risks.

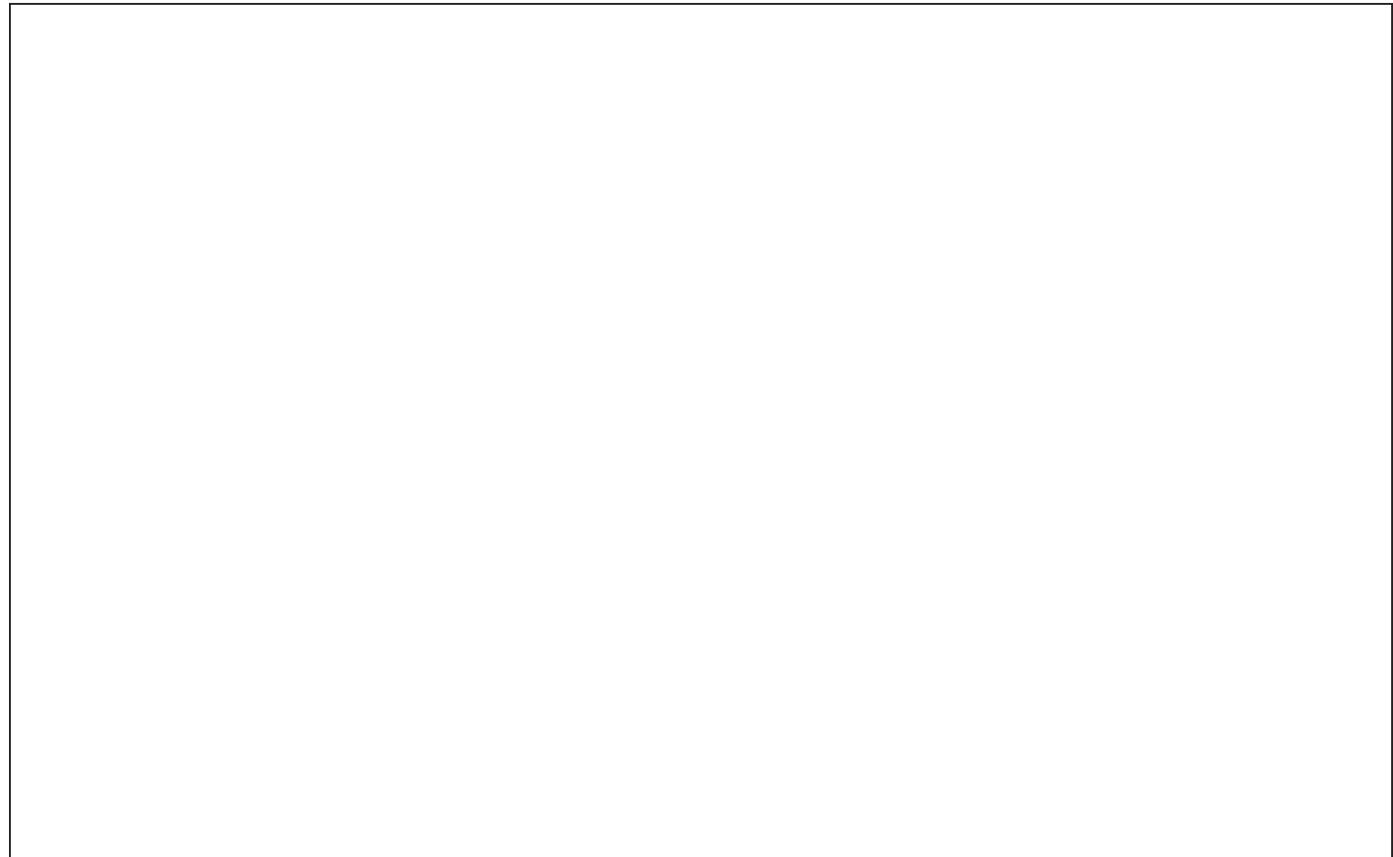
Contract Management Software

Companies wanting to speed business operations, maximize profitability, reduce contractual risk, and—most importantly—demonstrate compliance with the requirements of the Sarbanes-Oxley Act need to evaluate and create a plan of action for improving their contract management operations. Fortunately, leading-edge companies are beginning to address these issues with a new class of enterprise software. This software enables the central creation and storage of contracts electronically and the automation of the contract life cycle, thus, delivering better contract performance. Organizations are recognizing the need for such solutions. According to analyst group Gartner, the contract automation industry will top \$20 billion by 2007.

Contract management solutions enable greater visibility into contracts by providing an electronic repository to ensure that contracts are never lost and that they can be accessed quickly and easily across the entire organization.

Different functional organizations, such as legal, finance, or operational units, can view the contracts using their own filters. Such a repository also enables a large distributed organization to maintain only one version of the contract, yet allow access to it throughout the organization. With search capabilities, terms and clauses within contracts become quickly and easily accessible as well.

Contract creation tools simplify the process of developing and maintaining internal controls over the contract creation process. Organizations can create contracts using standard templates and a comprehensive library of clauses that are pre-approved and protect the interests of the company. These tools also offer automated workflows to track deviations from standard terms, ensure that appropriate approvals are obtained, and incorporate audit trails. These systems can be integrated with ERP systems, so invoices, payments, and deliveries accurately reflect what was originally negotiated within the contract.



Using contract risk management tools, organizations can better track important risk elements, such as contingencies and interdependencies. It is also easier to monitor and enforce regulatory requirements. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) defines standards and requirements for maintenance and transmission of health information that identifies individual patients. Organizations must make sure that their dealings with “business associates” adhere to the privacy regulations. Business associates include organizations that receive health information from a covered entity, and those who receive or create protected health information on behalf of a covered entity (e.g., lawyers, auditors, third-party administrators, billing firms, disease-management vendors, utilization-management software, and prescription-benefit-management companies). The regulation requires covered entities and their business associates to have a written contract that binds business

associates to the same use and disclosure limitations as the covered entity. Healthcare organizations are using contract management systems to ensure that all their contracts with business associates are written and managed in compliance with HIPAA regulations.

When a contractual risk is triggered through an external event, such as a bankruptcy or nonperformance by the other party, notifications can be automatically sent to the right people within the organization who can proactively respond to the risk.

Finally, such systems offer highly flexible and configurable reporting capabilities that meet both the day-to-day operational requirements for contract managers and the disclosure requirements of the Sarbanes-Oxley Act. Contract managers can use these reports to keep track of information such as contract expiration and milestone completion. CFOs can report on the risk exposure across contracts, such as total outstanding leases or forward-purchase commitments.

Conclusion

The corporate scandals of the last 18 months have resulted in investor skittishness and an erosion of trust among corporate institutions and leaders. Corporate boards and leaders need to regain that trust by demonstrating commitment to higher standards of accountability and adherence to provisions of the Sarbanes-Oxley Act. A contract management system will give managers the tools necessary to increase internal controls in managing contracts. Simultaneously, such a system can provide investors with a higher level of transparency and disclosure into what is truly going on in a business. **CM**

Endnotes

1. Jerry Useem, “In Corporate America It’s Cleanup Time,” *Fortune Magazine*, (September 2, 2002).
2. Kathleen Day, “Firms Still Fall Short on Disclosure, SEC Says,” *Washington Post* (February 28, 2003).