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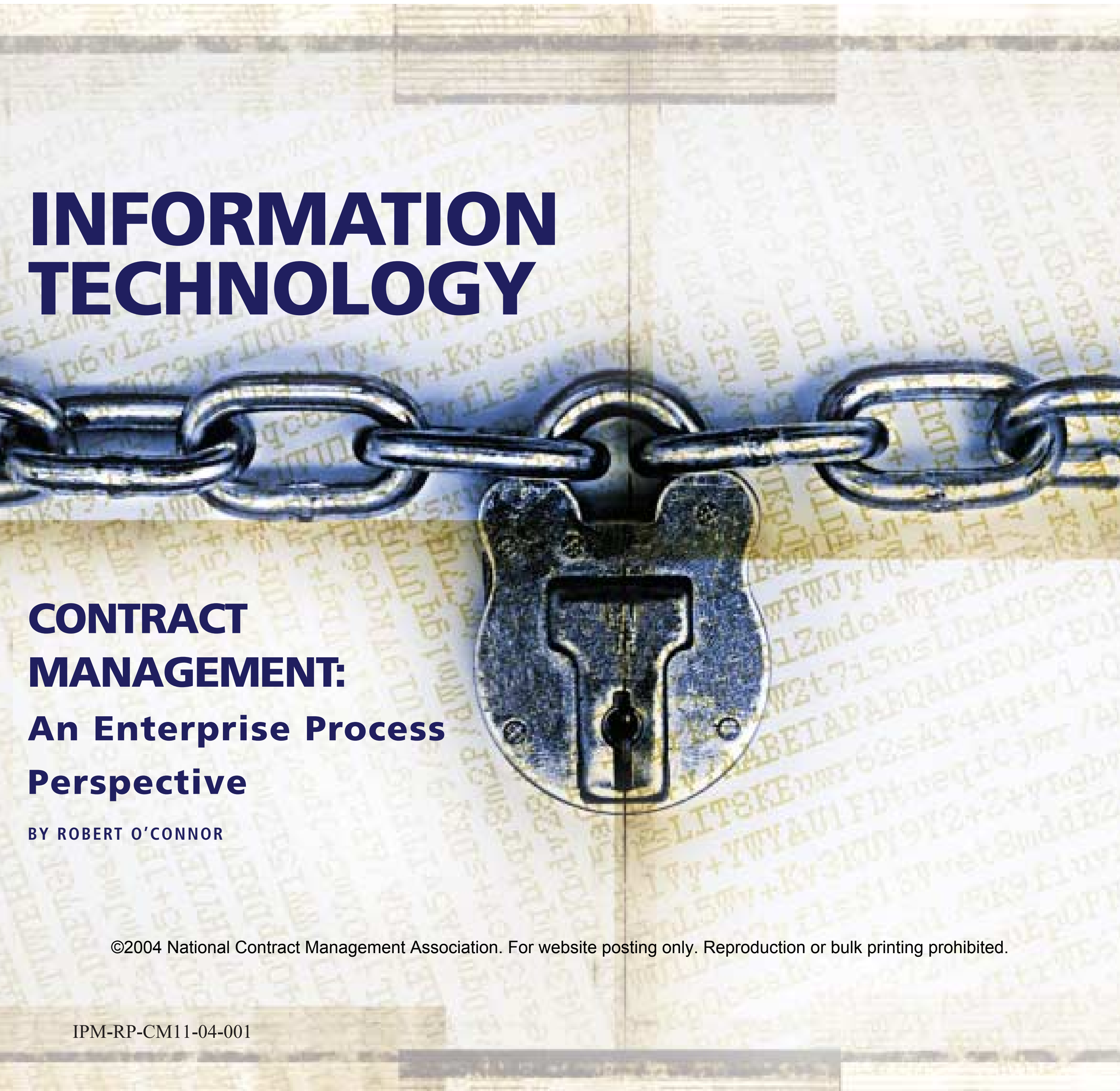

INFORMATION TECHNOLOGY

CONTRACT MANAGEMENT: An Enterprise Process Perspective

BY ROBERT O'CONNOR

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Today's complex customer relationships require a formal contract management process to ensure optimal revenue performance.

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World-class contract management requires that different functional areas perform in a coordinated way across the whole life cycle of a contract. Sales, finance, and legal resources may take the lead on hammering out the deal, but operations, accounting, and support must perform over the long term to optimize the associated cash flow.

Unfortunately, these resources are often so focused on their specific tasks that critical handoffs and data flows can get mishandled. As a result, key revenue opportunities, such as price increases, performance bonuses, and other incentives that are hard won in negotiation, may be lost in execution.

The link between contracts and accounting is important for many reasons—primarily because contracts determine how and when you can recognize revenue on your financial statements. Revenue from upfront deliverables, ongoing services, and event- and usage-based consumption are all determined by the contract. Many companies negotiate these terms on an account-by-account basis, creating a massive data set that should (but frequently does not) drive all downstream accounting processes. Without a formal contract management process, billing, revenue scheduling, allocation, recognition, reporting, and forecasting are laborious and error-prone.

Enterprise financial systems are supposed to act as a safety net, formalizing workflows across the organization. But very few companies have implemented their accounting systems so contract data flows directly into their core financial processes.

There are a number of reasons for this:

- Systems are deployed departmentally;
- Capabilities for order entry are not designed for the specifics of the business model; or
- Revenue and contract management functionality is not well integrated.

As a result, processes cannot be streamlined. Instead, ad-hoc interventions are needed to gather and reconcile order information from sales, pricing updates from marketing, and recurring revenue schedules from service and support. This makes finance operations inefficient and

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introduces risks into key financial reporting processes.

Managing Growth

The problem becomes especially severe or sensitive when the volume and complexity of contracts increases. The larger the existing customer base, the more money is at stake and the more likely it is that revenue opportunities are being missed. Tracking all the dimensions of multi-element contracts across hundreds or even thousands of current customers is typically beyond the scope of spreadsheets and customized applications. There are many ongoing challenges, such as synchronizing with all the contract additions or amendments that customers request, and incorporating changes in product strategy, licensing/ royalty arrangements, or discounting practices that the company makes on its own. Unless contract management and accounting processes are fully integrated throughout the enterprise, scaling up exposes weaknesses. When properly remedied, however, the result can be a far more robust and flexible financial infrastructure.

A Case Study

That's just what happened to Tumbleweed Communications, a provider of secure Internet-messaging products for enterprises and government agencies. Tumbleweed's financial data was fragmented across two enterprise systems and more than a dozen spreadsheets in different departments. The sheer volume of transactions, plus the fact that the company manages many large deals with unique elements, created a host of difficulties.

As Kathy Fox, Tumbleweed's director of revenue accounting, explained, "There were reconciling differences between the way accounting and sales departments viewed orders. It was taking us too long to close the books each month. And, it was very difficult to generate some of the reports management needed, such as the maintenance and support amortization by product, by region, and by customer."

Fox and her team approached these problems from the perspective that they were all caused by same underlying business issue. By designing an integrated contract management and billing process that tracks key information from the moment an order is entered, Tumbleweed gained greater control over its cash flow and better visibility into its revenue numbers.

"Orders are now entered into the system once. Then, finance simply runs a report to find all the open orders that need to be billed, allocates the revenue, sets up deferred schedules, and records the appropriate revenue," Fox said.

Contract management, order entry, billing, and accounting activities are now part of the same process, and sales and finance are no longer keeping separate spreadsheets and debating the status of orders. Billing and collections cycles have been reduced, maintenance contract renewals are now negotiated well in advance of expiration dates, and deferred revenue calculations are processed in accordance with the most current contract terms. "The streamlining of financial information that comes from working off of a common database has produced efficiencies across all our accounting processes."

Complex Contracts Means Complex Billing

A state-of-the-art billing system can mean the difference between being the first to bring innovative products and services to market and being a follower. It's fairly easy to add new services, solutions, and purchasing options to a contract, but having the financial infrastructure to back it up is another story.

To be fully operational, today's sophisticated business models typically require billing to be well integrated with customer management, contract information, and revenue recognition processes. Information from your active customer contracts at the front end must be integrated with revenue recognition accounting processes at the back end. However, billing and revenue should be independent, coordinated processes that are each controlled by unique business rules derived directly from customer agreements. This separation provides enormous adaptability to support innovations in marketing and sales, as well as far deeper financial data for analysis, reporting, and forecasting.

Tumbleweed found that there were a number of additional advantages to this approach, particularly for capturing the recurring revenue from its customer base.

"We now have visibility into which contracts are coming up for renewal, allowing us to work with customers a couple of months in advance," said Tim Conley, Tumbleweed CFO. "As a result, we're able to bill and collect sooner than we have in the past, and we can report the full granularity of maintenance revenue by product line."

Accounting for Multi-Element Contracts

One of the key accounting challenges for companies that use multi-element contracts is handling deferred revenue. Multi-element contracts involve bundled products and services that each must be accounted for very differently, usually on a line-item level and frequently on a deferral basis. With potentially thousands of line items in thousands of agreements, managing deferred revenue can be a substantial issue. Scheduling, allocating, and recognizing deferred revenue in accordance with ever-more complex accounting guidelines and legislative requirements is a source of pain for many businesses because conventional approaches do not handle deferred revenue very well.

The challenge gets even more daunting for business models involving complex pricing schedules, multiple currencies, vendor-specific objective evidence (VSOE), and percent complete revenue recognition. The complex accounting calculations required for compliance, with guidelines such as SOP 97-2, SOP 98-9, SOP 81-1, SAB 101, and EITF 00-21, can affect multiple contract elements, future recognition schedules, and general ledger accounts.

As a result, determining how sales bookings flow through deferred revenue to financial statements requires mastery of some very complex accounting, including

- Allocating component revenue based on SOP 97-2 VSOE requirements,
- Calculating residual carve-outs according to SOP 98-9,
- Applying percentage complete according to SOP 81-1,
- Recalculating allocation across revenue categories based on pre-negotiated price triggers,
- Forecasting the flow of revenue through deferred accounts into recognition schedules, and
- Accounting for currency fluctuations.

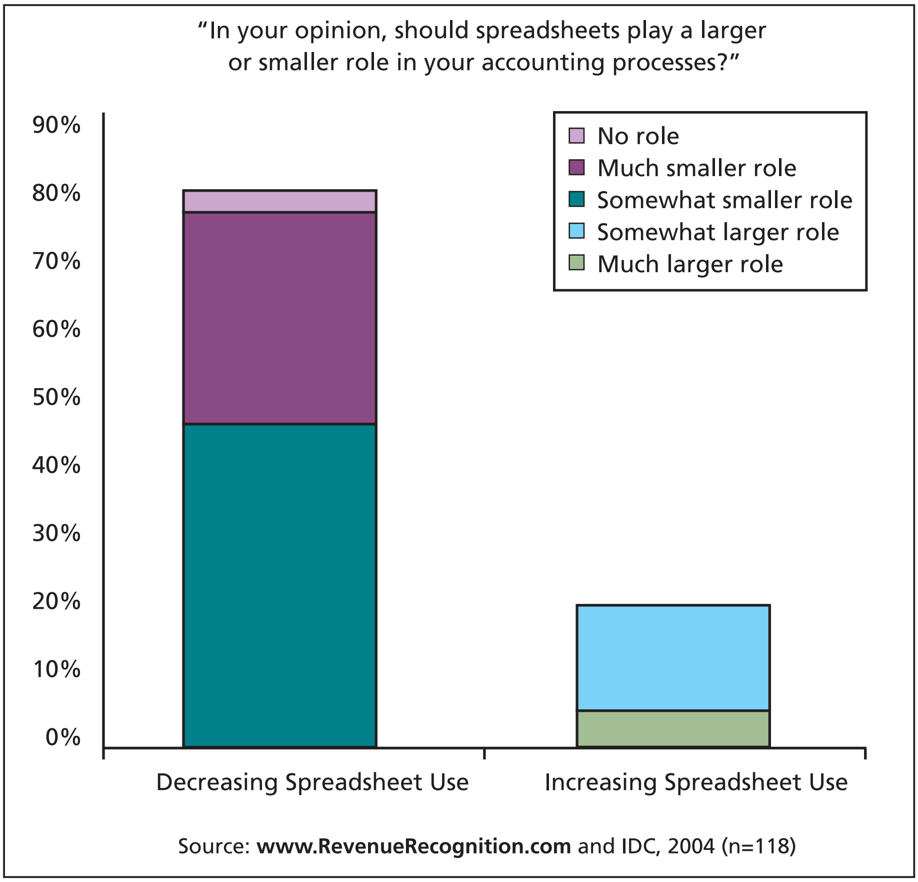

Figure 1.

All of the source data for these activities is derived from contracts.

Lacking a single source for current contract data, however, there are two alternatives: customize existing applications or develop complex spreadsheets. Neither of these choices is ideal. Customizations often are expensive to build and maintain, void the original vendor support agreement, and can degrade system performance. Spreadsheets are prone to error, undocumented, and hard to audit—plus, it takes much more time for manual data extraction, cleaning, combining, processing, validating, formatting, and reporting.

They also can exacerbate differences of opinion across departmental areas. "We were relying on a multitude of spreadsheets to do all of our reporting," Fox explained. "There were probably six or seven spreadsheets in finance, two in sales for pipeline and orders, and then marketing and business development also had their own spreadsheets. We were all sharing information, but none of the spreadsheets were in complete agreement."

This is representative of how many organizations use spreadsheets and is also a key indicator that an enterprise process approach is needed. It is no surprise, therefore, to see that a recent study conducted by RevenueRecognition.com and International Data Corporation found that companies are looking for ways to eliminate spreadsheets in their key accounting processes **(see Figure 1).**

Defining the Problem

It is one thing to see the symptoms of a dysfunctional contract management process and quite another to clearly define it as a business process that occurs across departmental areas.

Key symptoms that current contract management processes are not working:

- Management reporting is insufficient.
- There are multiple points of data entry for orders.
- Different departments track orders in different ways.
- Spreadsheets are needed to calculate schedules for deferred and recognized revenue.
- Accurate bills do not always go out on time.
- Audits are resource- and time-intensive, particularly concerning revenue and expenses.
- Capturing recurring revenue from contractual elements such as maintenance and support is labor-intensive.

However, this insight is critical to understanding how to solve the underlying cause and not waste time and effort treating the wide variety of symptoms.

Problems with broken contract management processes typically manifest themselves at the senior management level, especially regarding revenue. Timely, detailed reports are inconsistent, inaccurate, or unavailable. Data must be extracted and analyzed offline because there is no link to the source. It is difficult to get good schedules for how contract-based revenue will become available to the company. As a result, forecasting is nearly impossible and management must rely on infrequent, high-level snapshots to gauge corporate financial health. See the sidebar on this page for details.

Yet, management reporting turns out to be a good place to start defining the specifications for an integrated contract and revenue management process. Once management requirements are established, the data flow can be mapped back to contracts, and deficiencies in the process can be exposed.

While the mapping process occurs in reverse order—from reporting back to the original contract—the resolution process typically starts at the beginning with data entry. If data entry is fragmented or replicated in multiple areas, that immediately creates problems. Different systems contain different parts of the picture, keystroke errors are more likely to take place, and a lot of extra effort is wasted to control the overall quality of the data. However, if entered into a single repository, this data set can very efficiently drive all the downstream processes necessary for billing, accounting, and analysis.

The next area to examine is existing systems. Many companies have multiple applications for sales force automation (SFA), customer relationship management (CRM), and financials. As a result, historical data is hard to access and processes have not been fully streamlined. A full business process review is required to access the technical, process, and organizational issues involved. The good news is that with today's industry-standard data integration tools, much of the existing data can be successfully aggregated, so even if the data cannot be physically consolidated, the infrastructure as a whole functions as if it were.

Now we get to the details of integrating contract processes, controls, and data flows with key accounting activities for billing, reporting, and forecasting. This occurs at both the systems level and at the organizational level. Separation of duties, access control, as well as user authentication and activity-tracking, must all be implemented with respect to both key systems and key personnel. The system should be primarily responsible for

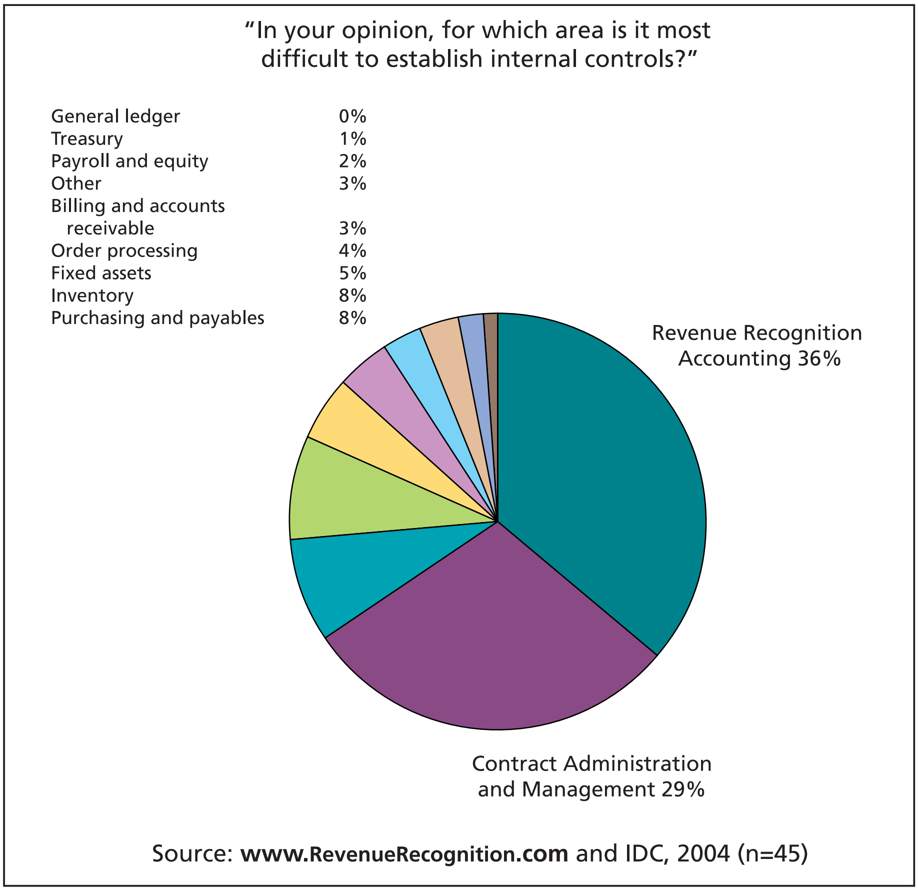

Figure 2.

data integrity (aggregation, complex calculations, billing and revenue schedule generation), audit trail production, and entry-locking, so changes cannot be made after this point. Personnel are primarily charged with designing the processes, entering data, detecting and preventing fraud, and analyzing the data for key insights into the business. This is not just good business practice—it is a requirement for compliance with the latest accounting guidelines and legislation.

The "404-Pound Gorilla"

The Sarbanes-Oxley Act of 2002 requires sweeping changes in our nation's capital markets. One of the most demanding changes is stipulated in Section 404, which mandates that companies comply with a wide range of financial management and reporting requirements. Specifically, internal controls over all financial transactions throughout the enterprise must be in place, operational, and continually monitored.

"With respect to Sarbanes-Oxley, we found that manual processes just do not provide enough evidence," explained Fox. "Obviously, if you are managing your business in spreadsheets, there's a lot of room for error and manual intervention. Now we have the system controls to lock it down. For example, our sales operations can go in and input orders, but they can only view billing and revenue recognition data. In a spreadsheet, anyone can go in and make edits, and we would be none the wiser—this way, we have much better internal control."

Contracts are a key piece of the domain that must be effectively controlled and reported on under Sarbanes-Oxley. There should be no potential for manipulation at any point in the continuum from order entry to reporting. That is as close to a mandate for integrating contract and accounting processes as you can get. But, as Figure 2 illustrates, contract administration and management and revenue recognition accounting stand out as the two most difficult areas for establishing internal controls, according to the survey by RevenueRecognition.com and IDC.

Solving these two problems as part of a single process creates a number of advantages for compliance efforts. First and foremost, a transactional audit trail for all revenue and contract related activity is generated. Revenue data is integrated with contractual terms and billing histories to track how, why, when, and by whom every revenue related event was processed. The result is a solid foundation for complying with the revenue-reporting requirements of Sarbanes-Oxley's Section 404, and for storing the aggregated data necessary to manage the business with greater clarity.

Additional benefits of an integrated approach to contract and accounting processes include the ability to

- Capture 100 percent of ongoing revenue as negotiated in multi-year agreements;
- Simplify the administration and accounting for multi-element contracts;
- Optimize and automate revenue processes to ensure proper controls are implemented;
- Provide visibility and alerts for all revenue events to ensure that corrective intervention is possible;
- Improve the integrity of revenue data;
- Increase productivity by eliminating unnecessary manual processes;
- Enhance process-monitoring, separation of duties, and user authentication;
- Access detailed revenue histories;
- Report on revenue by embedded components, salesperson, partner, product line, etc.;
- Forecast deferred revenues by product, customer, and general ledger account; and
- Forecast future revenue by customer, product, and byproduct against billing schedules.

The Proof Is in the Audit

The audit is when key reporting capabilities are put to the test. It can be very time-consuming for the finance department if records have to be investigated across multiple systems and functional areas.

"In the past, it probably took us five days to get through all the revenue data to support the audit," said Tumbleweed's Fox. "With integrated processes for order entry, billing, and revenue accounting, it took us approximately two days. The amount of effort was reduced because the reports are more readily available, especially with respect to deferred amortization."

Contract management and administration is a critical enterprise process. It should be engineered to provide a seamless data flow to drive all downstream accounting and reporting activities. But, there are a lot of details that must be handled correctly to ensure that control, flexibility, and accuracy are all simultaneously optimized. Here are the critical success factor recommendations, as follows:

- Take a process approach;
- Design around management reporting requirements;
- Coordinate technical and organizational issues across functional areas;
- Consolidate data in a single repository with a single point-of-order entry; and
- Incorporate proper controls at every step.

By addressing these fundamentals, an effective enterprise process for contract life cycle management can be established. This process is essential for capturing all the financial transactions that are involved in successfully managing large numbers of unique customer agreements. **CM**