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The CFO's Wish List

MANAGING CONTRACTS CAN SAVE YOUR COMPANY MONEY AND HELP IMPROVE YOUR COMPETITIVE ADVANTAGE.

BY KEVIN COLLINS, CPA

WHAT ARE SOME OF THE MOST PRESSING ISSUES financial executives will have to deal with this year? They range from gaining increased visibility and control over internal operations to establishing and maintaining good relationships with suppliers and customers.

This means concentrating on business basics—critical issues like cost control, productivity improvement, and financial reporting. A major part of such an effort is good contract management.

As a CFO, I deal with these issues daily, so I've put together a contract management "wish list" we financial professionals can use to stay focused on profitability.

Wish #1: Increase Enterprise Contract Visibility

New legislation that has been enacted to prevent a recurrence of recent corporate scandals has significantly increased the need for management to have complete visibility into all company activities. Many business technology solutions—including management information systems, production automation systems, and data warehousing and data mining techniques—have opened windows into various areas of a firm's production, shipment, and customer relations activities but, unfortunately, not into all of the critical areas. Ironically, most don't provide useful information regarding how well a company is performing in relation to its contracts and transactional commitments. Likewise, management is often not able to tell how the company's own suppliers are performing relative to contract incentives intended to drive business performance and profitability. These areas are critical in terms of a company's financial health and legal exposure.

Considering that the number of active contracts in a typical *Fortune* 1,000 company reaches between 20,000 and 40,000, it's obvious that information management on this scale requires an advanced IT solution, particularly a system dedicated to storing, managing, transacting, and analyzing contract information.

These requirements will lead to a rapid expansion of the enterprise contract management (ECM) sector. Enterprise contract management provides the central repository for a company's contract information and provides the tools management needs to monitor performance and take corrective action when necessary. A fully functional ECM system incorporates analytic software that automatically cross references data from manufacturing, shipping, or finance with the terms of the associated contracts and alerts management to discrepancies and potential problems.

Perhaps the greatest benefit an ECM system can provide is the ability to ensure contract compliance. Compliance has a direct impact on improving a company's revenue and cash-flow positions as well as the indirect benefit of avoiding the need to commit resources to handling the problems related to contract noncompliance.

Wish #2: Reduce Days' Sales Outstanding (DSO)

Every day that accounts receivable remain uncollected, a company's cash-flow position is degraded, and its competitive options are reduced. DSO management is an item of critical importance to all senior finance executives and can often provide significant challenges.

In the past, DSO was seen as a problem best left to the collections process. This is a reactive strategy that doesn't allow financial professionals to pre-empt the issues causing the DSO in the first place, which usually include incorrect invoices, mistakes in shipment of merchandise (too much product, too little product, late arrival, or early arrival), mislabeled products, or products that aren't packaged to customer specifications, to name a few.

The DSO issue requires a comprehensive solution that my company has termed a DSO Resolution Network. It targets the issues that can lead to DSO problems so CFOs and their staffs can take action before there *is* a problem.

A DSO Resolution Network typically includes:

- Creation of agreements,
- Ongoing management of contracts,
- Compliance monitoring,
- Management of receivables ledger,
- Collection of delinquent accounts, and
- Resolution of invoice disputes.

Wish #3: Minimize Contractual Nonperformance

When a company enters into a contract with a supplier, there's a risk that the supplier could inadvertently fail to comply with all the terms of that contract. If this risk isn't managed effectively and the supplier doesn't comply with the contract, the company's supply chain may be impacted, it may not be able to honor its commitments to its customers, and its revenue and margins may be adversely impacted.

For example, a company that manufactures tractors will have agreements with several suppliers for components such as fuel tanks, engine parts, paint, and softtrim. If any of these suppliers violates its contract, the tractor manufacturer's supply chain may be impacted, and ultimately it may not be able to produce and ship finished products, thus affecting its financial situation.

These risks (and all others that involve a company's agreements) can be managed effectively through the use of an ECM system that will provide the CFO and other senior management with information as to how the company's suppliers are performing in relation to their contracts. If the supplier isn't meeting its contractual obligations, the company can quickly take action and prevent the same issue from occurring again. With this information, the CFO can take corrective action when necessary and thus minimize the risks stemming from a supplier not honoring its contract.

Wish #4: Improve Audit Preparation

A key aspect of being prepared for an audit is the CFO's knowledge of exactly how well his or her company is performing against its contracts and how its suppliers are performing to their agreements. This capability requires the company to maintain accurate records on its active contracts and link that information to its various ERP systems. This can be made possible by creating a central contract repository that includes sophisticated database and analytical tools.

The financial picture that results from this system will be more accurate and meaningful to the company's executives as well as its auditors because every recorded transaction can be matched to a specific agreement. Currently, many companies use paper-based contract management procedures that basically involve storing contracts (both buy and sell side) in filing cabinets, sometimes in disparate locations, and only referencing the documents when a dispute arises. That kind of system makes it difficult to ensure that any given transaction is in compliance with the related contract. Further, in this environment it is all too easy to miss key contract milestones, which in turn could lead to failure to realize specific volume- or time-based incentives.

In 2003 and beyond, the pressure for more expansive auditing procedures will continue to grow. The prudent executive will act now to put the tools in place to preempt calls for greater disclosure and visibility, thereby improving the overall audit process for the audit committee, auditors, and senior management.

Wish #5: Improve the Financial Planning Process

The ability to accurately forecast a company's revenues and expenses is vital to planning for the future as well as providing correct guidance to investors. Again, in order to do this the CFO needs to have an exact picture of current agreements with customers and suppliers, which he or she can get from the comprehensive contracts repository I mentioned earlier that incorporates the tools necessary to extract the vital cost and revenue data.

Given the ability to access all of the company's active contracts and evaluate their financial implications, executives can forecast financial information with a higher degree of accuracy. This forecast will be used for the company's internal business planning exercises and will also be used to provide guidance to financial analysts or investors.

Wish #6: Strengthen Relationships with Suppliers/Customers

Every company needs to maintain good relationships with global suppliers and customers, and the status of these relationships often determines whether a company is successful or not. The big question is how to maintain positive and mutually beneficial relations with both suppliers and customers without sacrificing revenue or quality.

One of the most effective ways is to know what a company has committed to and to deliver on that commitment. How often have relationships been damaged because one or both parties to a contract don't adhere to all of the terms and conditions of that agreement? In many cases the answer, unfortunately, is "too often."

Effective contract management will help ensure that a company meets or exceeds the expectations of its business partners (customers and suppliers) through consistent compliance with their contracts. This will lead to strong relationships, increased revenues, and reduced expenses. Further, by knowing what its suppliers have committed to, a company can effectively work with them in a collaborative way to ensure that the contract is satisfied. This will help a company maintain a reputation as a preferred trading partner.

"A key customer relationship should be monitored like a patient in intensive care," says Dale Hagemeyer, senior research analyst, CRM Practice, at Gartner, Inc. "You want to continuously monitor critical metrics about how the relationship is doing…not just on a quarterly basis. Otherwise, the customer relationship, like the ICU patient, is dead and buried before you realize and can take action."

Wish #7: Enhance Sourcing and Procurement Processes

Senior executives concerned with reducing costs and improving margins are increasingly focusing on procurement. By improving the performance of the procurement function, management can reduce operating costs and ultimately improve its bottom-line performance.

Because procurement is the gateway between the company and its various suppliers, it's important that procurement professionals implement best practices wherever possible. These best practices will ensure that the company keeps costs under control while maintaining positive relations with its best suppliers.

Procurement best practices include:

◆ Establishing common procurement data definitions across the company,

- Improving access to certified/approved suppliers,
- Identifying the need for a new contract quickly,
- Streamlining the procurement process,
- Optimizing repetitive purchase compliance.

Wish #8: Automate the Contract Management Process

No company can afford to maintain large staffs to handle routine tasks if an automated solution is available. Yet a disproportionate amount of human and material capital is committed to drafting, reviewing, editing, filing, and retrieving contracts and contract-related information. A good indicator of the extent of this capital is the number of people who are responsible for separating valid from invalid deductions. (One example of a deduction is a short payment made by a retailer who receives damaged goods from a manufacturer and "deducts" the value of the damaged goods from the invoice.) Industry experts estimate that there are more than 20,000 of these people in the U.S. consumer goods industry alone. This isn't effective contract management.

Rather than continuing to invest inefficient resources to combat this issue, management should consider deploying an automated enterprise contract management system that will allow for the rapid creation, review, and storage of standard contracts. Further, this system would allow the company to effectively engage in the analysis of existing contracts as well as the renegotiation of contracts based on solid data and analysis.

Wish #9: Reverse the Deductions Trend

Referencing the previous wish, one of the most significant and disturbing trends is the unprecedented growth in the use of invoice deductions, which has been estimated at $10 billion a year and shows no sign of slowing down in the near future. According to a survey by the Grocery Manufacturers of America titled "Invoice Accuracy: 2002 Industry Survey & Benchmarks," the primary causes of deductions were promotions, billbacks, and pricing. Companies that reimburse deductions must manage them effectively since reversing them may be impossible.

"Let's face it, in the U.S. manufacturer/retailer relationship, deductions are like death and taxes—they are a fact of life," Dale Hagemeyer says. "With taxes, the best you can do is minimize them. Similarly, with deductions, the best you can do is to identify and quickly act on the unauthorized deductions and to clear the authorized ones as quickly as possible. With trade spending averaging

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13% of sales revenues in the U.S., the magnitude of deductions can be staggering without an automated system to deal with them effectively."

When these facts are considered in light of current trends in profit margins, the true severity of the problem hits home. To address this issue, CFOs need to implement a deduction management solution that is able to provide users with detailed deduction and past-due reporting and tracking information as well as ensure that the information is then forwarded to the appropriate person for action. To be effective, this system needs to interface directly with the company's existing ERP systems.

The deployment of an effective deductions management solution as part of ECM will help to streamline business processes, improve staff efficiency and effectiveness, increase positive cash flow, and reduce days' sales outstanding and accounts receivable. This system should be a priority for the forward-thinking CFO.

Wish #10: CFOs Changing with the Times

It's clear that the role of senior finance professionals has changed dramatically even in the last 12 months. It's important for a CFO to have access to information so that he or she can effectively manage financial operations—cash collections, financial forecasting—including the audit and interaction with the audit committee. Equally important, a CFO wants to maintain value in his or her trading partner relationships. It's clear that an effective ECM solution can fill my wish list and deliver value to the company, its customers, and its stakeholders. ■

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