Reducing Supplier Risk

How Finance and Procurement can work together to manage working capital, enforce controls, and formulate corporate strategy

By Ari Salonen

In fall 2008, the world witnessed on a grand scale what happens when companies that we thought were solid institutions are in fact in grave danger of going under. While the financial behemoths shook the foundation of our financial system to the core and the impact rippled throughout the world, the events taking place underscored two major lessons: that appearances can be incredibly deceiving and that we're vulnerable if we don't find out what's really going on beneath the surface.

We should also heed these lessons in the supply chain. Supplier risk is a critical issue in today's economic environment where the financial status of suppliers can change rapidly, often without much apparent warning. Supplier issues can lead to quality problems, difficulties delivering the quantity of goods on time, or even bankruptcy—all of which would be detrimental to a buyer's business. Additionally, in today's economic climate where it's hard to get financing, it's often very difficult for insolvent suppliers to restructure their debts and emerge intact from a crisis.

Several major issues are making supply chain risk more prevalent: the ineffectiveness of traditional methods of monitoring risk in today's economy, corporate cost-cutting imperatives that are squeezing suppliers, and the disconnect between Finance and Procurement departments.

The old ways of monitoring risk are no longer valid. Simply monitoring supplier credit ratings or bringing in analysts to run annual or even quarterly financial audits on a supply base will often miss the early-warning signs that can be found in day-to-day transactions. Most companies haven't adapted their approach to monitoring risk to adjust to the realities of the current economic environment. In November 2009, Basware completed a follow-up study to our June 2009 *Cost of Control* survey of 550 CFOs in large organizations. (The June study featured insights from CFO and financial director-level respondents in the U.S., U.K., Scandinavia, Germany, Spain, Benelux, and France.) The November study shed light on strategic issues and challenges, including supplier risk, facing CFOs and CPOs (chief procurement officers) around the world. Interestingly, in *The Cost of Control: The Real Price of Cost Cutting* interviews, we found that many companies are mistakenly focusing on identifying major disruptive events in their supply chains while failing to address the more likely risks of smaller, incremental problems—such as suppliers cutting corners in quality and service or struggling in other ways to meet companies' demands.

The problems caused by failing to conduct ongoing supplier monitoring are exacerbated by the current approach to business that considers cost control and reduction "the new normal." Organizations' urgency to implement reactive cost-cutting measures is currently taking precedence over a longer-term investment focus. Some industries, such as automotive, have been negotiating tougher terms with suppliers to gain short-term savings. But these companies need to make sure to strike the right balance. When suppliers are forced to succumb to unrealistic demands and significantly reduce prices, it may impact their cash flow, profitability, or even their viability. In the CFO and CPO interviews, we found that the majority are aware of the instability in the supply chain caused by constant cost-cutting efforts, and they're striving to keep costs low in ways that won't impact their suppliers, such as by using automation to achieve efficiency gains.

Finance and Procurement Disconnect Opens Door for Supplier Risk

Another factor increasing supply chain risk is the disconnect between CFOs and CPOs. Tensions between Finance and Procurement departments typically focus around issues of ownership, authority, and transparency. There's a lack of clarity about who's in charge as well as disagreement about who should have ownership of the supply chain.

It's difficult for CFOs and CPOs to be truly effective and knowledgeable about supply chain risk when they lack visibility into what's really happening in Accounts Payable (AP) and Purchasing, as well as access to key information across the financial value chain. CFOs and CPOs need near-real-time visibility into the company's exposure (such as cash flow and the supplier base) in multiple areas—such as vendors, countries, currencies, and industries. Companies also need this visibility to be able to comply with regulations and policies. Without the proper visibility and control of end-to-end purchase-to-pay functions, companies aren't aware of their unrecorded liabilities, they can't see where or how money is being spent, and they can't manage spending or cash flow effectively. While Procurement has information about a company's spending plan, Accounts Payable has information about how and where the money has actually been spent—how the spend management plan has been implemented. Critical information about supplier risk is accessible only when organizations have visibility into both the procurement and accounts payable processes. Warning signs of risk can be identified from a supplier's behavior in the procurement or accounts payable arenas. For example, a supplier who's running low on cash—and might have a higher risk of failing—might require shorter payment terms or grant higher discounts for early payment.

In the June 2009 *Cost of Control* study, 41% of CFOs said that they consider supplier stability to be a major risk to financial strategy. Ironically, findings from the study reveal that, despite a high-risk economic environment, CFOs are failing to recognize the importance of closely managing supply chains through Procurement. Only 28% of respondents to the survey said that they believe Procurement has a significant impact on financial risk exposure. The CFOs aren't adequately recognizing the value that Procurement can contribute to the financial health of their organizations. In addition to minimizing risk and ensuring the stability of suppliers, Procurement can identify ways to cut spending, such as by consolidating suppliers and benefiting from volume or early-payment discounts. For example, a company might have several suppliers across the country for the same commodity or product, such as office supplies. By consolidating the demand to fewer vendors, they may be able to negotiate better overall pricing or more favorable payment terms.

How to Manage Risk

Many world-class companies are able to identify and manage risk in the supply chain. Here are some of their best practices, along with recommendations on how to effectively manage risk, from Mark Frohlich, associate professor of operations management at Indiana University's Kelley School of Business:

Create a collaborative internal audit team to address risk. Internal auditors, whether they are employees or consultants, are often weighed down by many responsibilities, including determining the effectiveness of operations and the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and complying with laws and regulations. With such a broad charter, internal auditors unfortunately often push supply risk lower on the list of priorities. Yet it's important for an internal audit group to play a key role in analyzing the payables process and supplier risk. Organizations shouldn't consider supply chain risk as solely a Procurement, Finance, or Operations issue because it touches all areas of a business—from basic procurement to the outsourcing of shared services for IT, human resources, and manufacturing. By implementing a purchase-to-pay platform, Procurement and Finance departments can help internal auditors highlight potential risk areas in the supply chain. They can help identify supplier behaviors that may indicate instability, such as pushing for shorter payment terms or granting greater early-payment discounts.

Break down the barriers between Finance and Procurement. Only by working together strategically can the two departments make the decisions that will benefit the business as a whole. CFOs and CPOs have many areas of commonality and shared goals, including achieving savings, monitoring and controlling risk, and leveraging technologies and processes for greater transparency and value. By collaborating, CFOs and CPOs can effectively cut expenses, gain critical visibility and control, and mitigate potential liabilities. Organizations that achieve transparency throughout the entire purchase-to-pay cycle will be best equipped to manage and monitor risk and emerge from economic downturns in the best health. Breaking down the barriers between CFOs and CPOs can be challenging, but there are several recommendations for bringing the two groups together to address supplier risk and other key issues:

◆ Create a steering committee of key stakeholders to facilitate and focus on purchase-to-pay collaboration. It's important to include executives who are critical to the process, including the manager of Finance, manager of Procurement, CFO, CPO, etc.

◆ Identify clear metrics and goals that the committee will accomplish. Assign roles and responsibilities, and meet regularly to check your progress against your goals.

◆ Make sure everyone is seeing the same real-time data for all spending, supplier, payment, and other related information. When key financial decision makers have a single, unified view of spending and other purchase-to-pay processes, they'll be able to identify important issues and concerns and make better financial decisions. According to the June 2009 *Cost of Control* study, when there's a high degree of automation (more than half of the purchasing processes are automated), 55% of CFOs perceive a greater integration between Finance and Procurement, as opposed to 37% in organizations with low levels of automation.

Establish visibility across the financial value chain. Companies are using automated solutions to obtain visibility across purchase-to-pay processes by collecting relevant information (often from multiple sources such as enterprise resource planning (ERP) and finance systems) and enabling analysis, reporting, and decision making based on that information. By being able to see all aspects of company spending, from purchasing plans to invoicing, you can identify spending habits and uncover savings opportunities through volume discounts and other activities. Additionally, you can look at behavioral trends to identify potential risk with suppliers. Automating manual purchase-to-pay processes—from sourcing, contract management, purchasing, and supplier collaboration to invoice automation—provides visibility and allows professionals from Finance and Procurement to have real-time access to the same, accurate data. Automation also helps organizations manage spend, cash flow, and working capital, as well as effectively monitor, manage, and improve supplier relationships. Companies view purchasing and invoicing information to identify any potential changes in suppliers' quality and delivery and to adjust payment and other terms to help suppliers that may be in need. Visibility is also critical for achieving compliance and implementing financial controls. Transparency and a full audit trail enable companies to comply with the Sarbanes-Oxley Act (SOX) and other key regulations. In addition, by being able to view their actual spending practices, companies can see which policies need to be implemented and use automation to enforce these financial controls.

Actively look for behavioral trends. Once you have visibility, you can analyze the behavioral trends of suppliers to predict risk. Identify the criteria you need to measure in order to highlight red flags, such as potential quality problems or supplier performance issues. Using automated systems enables you to design and implement key performance indicators (KPIs) to gather information about behavioral issues, such as discount-taking trends, changes in payment terms, delivery dates, delivering the right quantity and quality of goods, frequent calls for payment before invoices are due, and more. Automated systems can audit stamp supplier delivery receipts—comparing the order to what the vendor actually delivered to the warehouse and what that vendor actually billed. Information about the behavioral trends of suppliers will give you a better day-to-day picture of their health. Combine this information with financial and banking data, and you'll be able to get early-warning signs of any problems, such as suppliers that start overbilling for the goods they deliver.

Prioritize your suppliers. Determine which suppliers are most critical to your business. For example, identify which suppliers are responsible for most of your orders and which provide mission-critical goods and services to your business. Once you've prioritized your suppliers, you can determine how you can partner with top suppliers to support the stability of their businesses.

Use automation to gather key information about supplier risk. Five-way matching enables companies to make sure that all steps in the purchase-to-pay chain are consistent and match: the order, delivery time and quality, quantity, contract terms, invoice. Purchase-to-pay software automatically matches and checks an invoice in five areas: information in the invoice, the purchase order, goods received, quality inspection, and a complete audit trail. While five-way matching is important for all businesses, it's absolutely vital in global supply chains where weeks or even months can separate the time between when orders are placed on one side of the world and eventually received on the other. Additionally, advanced automated systems provide N-way matching, in which any number of match points, in addition to the five-way criteria, can be added to the purchase-to-pay chain. For example, a company can check an invoice against any number of established business rules, such as corporate policies and practices (virtual contracts); legally binding contracts, such as purchasing contracts; bookkeeping rules; purchasing documents, such as electronic purchase orders and goods-received receipts; and basic data, such as supplier information. This automatic checking not only helps with supplier-specific analysis, but it enables compliance with SOX and other regulations, as well as compliance with contracts. It also allows companies to enforce controls that help prevent fraud. In the June 2009 *Cost of Control* study, 60% of CFOs at organizations that were highly automated were satisfied that the Procurement department had developed closer relationships with suppliers. The response was 48% at companies with low levels of automation.

Take action. Visibility into the information captured on spending, cash flow, supplier performance, and scheduled payments from automated purchase-to-pay systems will enable you to assess the level of risk and determine how you want to address it. Consider your actions based on the severity of the problem and the value of the supplier to your business. For example, you might consider changing terms to make earlier payments, bringing on new suppliers, or expanding your business with existing suppliers in a particular category. At the same time, consider readying your supply chain for long-term initiatives. Make sure to develop integrated and collaborative relationships with first- and second-tier suppliers to better evaluate and control risk in the supply chain. For example, companies can work with suppliers to jointly determine the key metrics for measuring supply chain/vendor performance, as well as share reports and analysis with suppliers to track and improve their performance. Also, any assessment of risk in the supply chain should look ahead to accommodate future needs. Determine which suppliers can provide the quantity and quality of goods and services you may need for future expansion.

Working Together

Purchasing and supply-side operations must be an integral part of risk awareness within all organizations. To effectively identify risk and move an organization forward, Finance and Procurement departments must collaborate and share information. CFOs need information about spending and must rely on the CPO's relationships with suppliers to identify and fully grasp the issues involved. Similarly, CPOs should take a more active part in formulating corporate strategy and be more innovative in executing it across the supply chain. By working together, Finance and Procurement can help companies achieve better working capital management, reduce costs, and mitigate risks. Accomplishing these goals and learning from the mistakes of the past can help companies emerge from an economic crisis stronger. **SF**

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