

## Three steps Procurement and Finance must take together to reduce supply risk

1. Enabling A/P to be an asset versus a liability when it comes to supplier relationships
2. Empowering internal audit and risk management to do a better job of analyzing supply risk
3. Focusing on building visibility into key supplier metrics and key performance indicators KPIs.

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## 1. Tackling Supply Risk – The Root Cause

When it comes to monitoring the financial condition of their supply base in the current downturn, most companies are struggling to keep pace with how fast this environment is evolving. One of the challenges is that procurement organizations, alone, will never be able to solve supply risk by themselves. Rather, they must work closely with finance leaders to mitigate the varied aspects of risk that can impact large portions of the business, gaining better visibility and controls into their overall procure-to-pay (P2P) process, among other joint initiatives, to take action decisively and effectively. Together, both groups must move quickly.

For many organizations, the current situation is similar to driving down a dark highway at the maximum speed a car will take you. Oncoming traffic comes at you in a flash. You feel every bump in the road but are moving too fast to anticipate them. Driving conditions can change on a dime, but you're traveling too fast to react in time. In other words, it is a lot like driving blind, which is the exact predicament many procurement and finance organizations are finding themselves in when it comes to keeping tabs on the financial condition of their supply base. In our current economy, key suppliers can go bankrupt in a matter of days or weeks. Or another might start to cut corners (or let an insurance certification lapse) because they cannot afford to maintain the same controls and standards of the past. Like driving at top speed in the dark, reality is coming at us faster than ever before. But when it comes to both shareholder and customer expectations, there are no excuses for driving blind when it comes to managing supply risk.

Given how fast the road is moving under us today, companies foster a false sense of security by monitoring supplier credit ratings or bringing in the MBA-level analysts to run once per quarter (or once a year) financial analyses on a supply base. Rather, what companies must do to proactively mitigate the impact of supply risk is to:

- Look closely at key supplier behavior and indicators on a more frequent basis
- Automate, monitor and track the overall P2P process
- Keep current information on up-to-the-minute internal reporting metrics
- Share information with key constituents to enable action.

By enabling these capabilities, companies can move into the supply risk passing lane, a position that is becoming all the more important given the pace at which supplier bankruptcies are accelerating. The American Bankruptcy Institute, an organization that tracks both business and personal bankruptcy trends and filings, found that in Q308 business bankruptcy filings in the United States rose by 38% over the previous year, based on the latest quarterly numbers available.

As supplier bankruptcy risk is clearly rising, CEOs, CFOs and procurement leaders face other types of supply risk as well. When companies fail to track, report, and manage supplier accreditations, certifications and standards, overall business risk increases as well. Consider how the US Federal government chose to make an example of Wal-Mart for failing to manage the labor credentials of contractors working inside stores. In other cases, The Gap, Monsanto and dozens of other large multinational companies have been caught up in contractor and supplier child labor scandals. To fully address these issues, multiple constituents inside organizations must take ownership of the issues, working together to ensure supplier compliance. Working together, procurement and finance can take action today, creating the right team to build increased overall spend and supplier visibility, enable better A/P coordination and results and deploy enabling P2P technology to drive compliance and overall risk reduction.

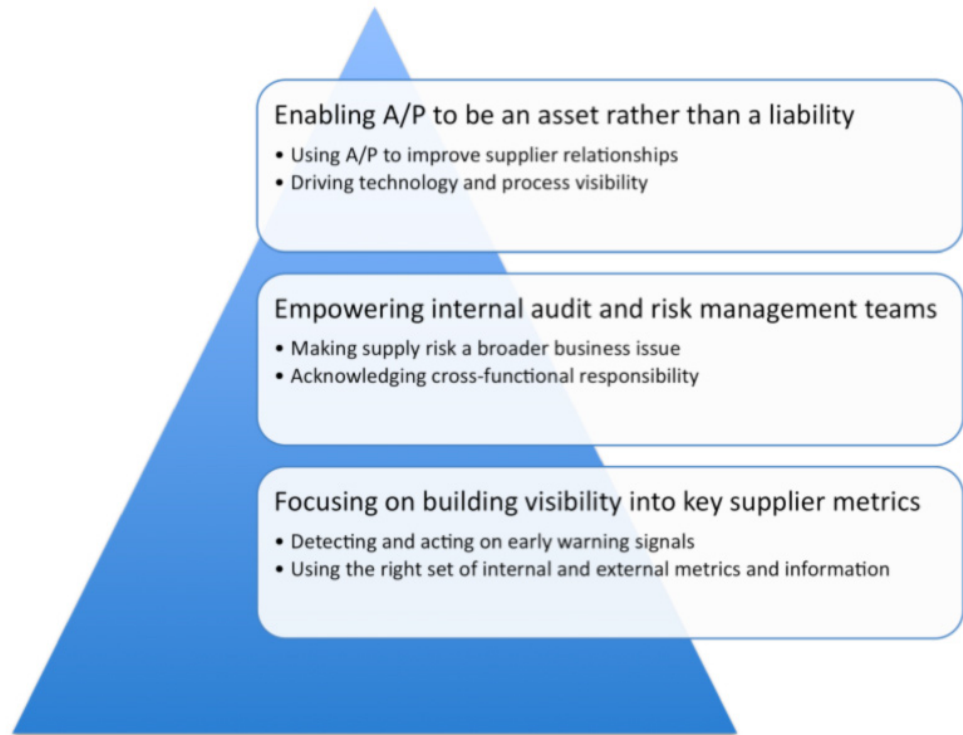


Figure 1: Procurement and Finance - Reducing Supply Risk Through Three Targeted Steps

## Global Bankruptcy and Default Forecasts

During Q408, D&B forecast that the year would end with approximately 35% more chapter 7 liquidation bankruptcies than the previous year. When a supplier files for Chapter 7 bankruptcy, companies can quickly face continuity of supply/service issues as their supplier shuts down operations in preparation for liquidating their assets. Default rates and insolvencies threaten European companies just as they do their North American brethren. According to a recent article in *The Economist*, "Standard & Poor's (S&P), a rating agency, reckons that 60-75 European companies from its speculative-grade category could default on a total of €20 billion-25 billion (\$28 billion-35 billion) of debt in each of 2009 and 2010, taking the overall default rate up as high as 11.1%". While worldwide defaults and bankruptcies are rising at an alarming rate, our research suggests that what may be of even more concern from a forward-looking perspective is the number of suppliers who are finding it difficult to obtain debtor in possession (DIP) financing. According to the *Wall Street Journal*, such financing largely dried up going into Q408, making it impossible for insolvent suppliers to restructure their debts and emerge from bankruptcy without going through liquidation.

## 2. Three Steps Procurement and Finance Must Take to Reduce Supply Risk

Procurement and finance organizations must collectively take three steps to reduce supply risk. These are:

1. Enabling A/P to be an asset versus a liability when it comes to supplier relationships
2. Empowering internal audit and risk management to do a better job of analyzing supply risk
3. Focusing on building visibility into key supplier metrics and key performance indicators KPIs.

### 2.1 Enabling A/P to be an asset versus a liability when it comes to supplier relationships

If you were to ask a typical procurement or vendor management organization whether A/P is an asset or a liability in their task to effectively manage suppliers, the majority would select the latter option. In most companies, A/P continues to be a weak link to building and sustaining supplier relationships - not to mention driving up supply risk. The primary reason for this is not just that suppliers typically view A/P organizations as the culprit for delaying payment. Rather, suppliers - as well as procurement, finance and operational business users - often lack visibility into the payment process. When a supplier submits an invoice in an ideal world, a series of workflow steps not only result in payment at or around negotiated terms, but also provide visibility throughout the process. Specifically, it is this transparency that can help procurement and finance organizations to reduce risk.

Invoice automation has become the key link between procurement and payment to create an open window into the payables and supplier management process, tying together both technology and business workflows to create visibility and coordination. On the most basic level, automation creates a set of benchmarks and baseline information to track and share both internally and externally. From a procurement standpoint, this ensures that suppliers are not necessarily paid any earlier, but that they have visibility into timing throughout the process. This level of visibility into the invoicing management process not only reduces risk by helping procurement and finance to better manage working capital, it also helps suppliers to better manage their receivables processes and timing, which reduces risk in their business and hence, overall supply risk for the buying organization as well.

### 2.2 Empower internal audit to do a better job of analyzing supply risk

Inside many companies, employees and managers look upon internal audit professionals with a disapproving eye, given that it is their role to find fault with business activities, processes, and procedures. But within procurement- and finance-driven supplier management activities, this fear is often overplayed. In many cases, internal audit teams turn their attention to supplier-facing procurement and finance activities on a periodic basis, and even then on a somewhat superficial level, ensuring only the most basic safeguards given their broad company charter.

Internal audit's charter spans functions to analyze the "efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations," according to Wikipedia. With such a broad charter, internal auditors - whether they're employees or consultants - may let supply risk fall even further down the list of areas to consider. This is a mistake.

Internal audit groups can and should play a key role in analyzing the payables process, looking closely at all of the internal and supplier management touch points that either encourage or reduce supply risk. This is central to success in today's environment because supply risk is not just a procurement, finance or operations issue. It touches all areas of the business from basic procurement to the outsourcing of shared services for IT and human resources efforts and manufacturing outsourcing. Throughout these efforts, internal audit can - and should - play a key role reporting to the executive team and the board when it comes to supply risk that can impact the business. To provide visibility into potential risk areas and help internal auditors in their efforts, procurement and finance should work together to provide a P2P and matching platform that enables persistent monitoring and analysis of internal buy-side controls. To enable the internal audit function to identify and reduce potential risks from non-compliance or fraud, companies should deploy invoice matching systems that:

1. Verify that an approved and properly coded purchase order exists
2. Monitor when an organization receives actual goods or services
3. Document the verification of quality and inspection
4. Provide a complete audit trail of the entire process for both PO and non-PO spend

Outside of the P2P process, procurement and finance should help internal audit teams conduct commodity risk and supplier specific or named supply analyses for key commodity areas for both goods and services. Finally, both groups should work together to help internal audit to certify that a company's overall payables and supplier facing activities meet generally acceptable internal controls and metrics for security, privacy and policy governance.

## 2.3 Focus on building visibility into key supplier metrics and KPIs

To reduce supply risk in today's fast moving market, a time when suppliers can transition from a financially healthy to precarious state in a matter of weeks, it is important for procurement and finance to look beyond lagging third-party indicators (e.g., supplier credit data) to proactively mitigate supply risk. A/P organizations must take a leadership roll on gathering this type of information. When they do it successfully, it can make the difference between having early warning of supplier financial challenges or no warning at all. But what types of information and KPIs can be most effective in providing this type of risk runway? Understanding whether suppliers are taking discounts with greater frequency (and for what types of invoices) can be helpful. In addition, looking at the frequency and percentage changes in supplier-initiated changes / renegotiation for payment terms can be useful (e.g., are there trends in how certain suppliers - either individually or those in a certain industry/supplier market - are attempting to renegotiate or modify payment terms). Other metrics and information to consider include looking at supplier banking information, paying particular attention to relationships with at-risk lenders who could withdraw lines of credit, asset based lending or other debt offers with their customers, potentially causing a supplier to face a capital crunch in an otherwise financially stable operating environment.

Additional types of non-financial information can be useful as well. Looking at other source systems including ERP, MRP, and source-to-pay environments can yield useful predictive

information on risk through such areas as supplier performance (e.g., escapes, PPM, SLA adherence etc.) Even basic quality and on-time performance metrics or qualitatively derived information from supplier scorecards can provide useful information about the financial state of a supplier. In fact some companies use only supplier performance and quality information - rather than financial or banking data - to proactively predict supply risk. But most companies will find that the combination of data from different systems with a specific focus on P2P and payables data yields the greatest potential insight into at-risk suppliers.



Figure 2: Combined Elements Drive Supply Risk Management Success

### 3. Reducing Supply Risk - A Collaborative Effort

The confluence of unprecedented economic turmoil and isolationist corporate infrastructure mandates a rapid and critical response to the supply risk challenge. Many economists, investors and politicians believe that things may get worse before they get better. Declining volumes and reduced overall demand, the global finance and banking crisis and staff reductions and redundancies are combining to put companies at greater risk than ever before. In this environment, organizations that confront supply risk simply by focusing on procurement and operational risk factors alone are unlikely to fully mitigate the risks that they have set out to manage. Given the operating climate we find ourselves in, those companies that fail to exponentially increase their focus and collaboration on reducing supply risk today will have to face even greater probabilities of catastrophic supply disruptions and potentially related challenges sooner rather than later. To some, these may sound like harsh words, but the reality is even harsher.

But by using a corporation's disparate, yet formidable, talent and resources in a collaborative fashion in tandem with technology, companies can avoid being blindsided by sudden supplier bankruptcies and other supply risks. Finance and procurement collaboration should be an essential component of these efforts. To successfully reduce risk, both groups must work together leveraging senior management attention that relies on the combined efforts of procurement and supplier management functional resources along with A/P, internal audit and other finance team members. Supported by this team, an underlying P2P technology platform



and the right set of benchmarks, KPIs and other internal and external supplier information to enable proactive insight into their suppliers, companies can reduce the odds of all types of supply risk negatively impacting their business.

Through its industry-leading technology platform, Basware has helped hundreds of companies to build better processes and visibility into their global P2P activities, improving functional coordination and collaboration, and reducing supply risk. Whether an organization is looking to reduce supply risk through a targeted invoice automation program that can complement other technology initiatives, or for a single platform that spans end-to-end P2P processes, Basware helps companies at all stages of procurement and finance maturity to gain greater control over the current economic environment and its impact on suppliers. At Basware, we have spent over two decades helping to bridge the process, functional and risk management gaps between procurement and finance in countries around the world. If you are curious to learn more about what we have learned about reducing supply risk through procurement and finance collaboration, we would welcome the opportunity to start a conversation.

To find out more about how Procurement and Finance can benefit from collaboration, please contact [juha.hakamies@basware.com](mailto:juha.hakamies@basware.com)



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