



Managing Relationships to Mitigate Supply-Chain Risk

In a challenging business environment, many finance executives are casting a worried eye not just on their own company's performance, but on the companies with which they do business. In addition to watching receivables closely, finance teams are turning their attention to the financial and operational performance of their suppliers.

In a recent CFO Research Services survey of senior finance executives at large U.S. companies, more than half of all respondents (55%) say that underperformance of vendors (including delivery delays and business interruption) is one of their most serious supply-chain management concerns. Finance executives seem to have learned the value of close attention to supplier performance the hard way: a majority of survey respondents (54%) tell us that underperformance of supply-chain partners has had at least some negative impact on their companies' financial performance in the last five years. How can finance executives contribute to efforts to reduce the risk of business disruption due to operational or financial shortfalls among key suppliers? Through a series of interviews, finance executives at leading companies describe the good practices that have helped their companies gain a measure of visibility and control over their sourcing partners' practices—and helped limit exposure when problems do arise.

Align interests

Some companies guard against disappointing vendor performance in part by choosing suppliers that have standards for quality and service that are as high as their own. In some industries, this dynamic is a given. Operating risk management in highly regulated, safety-focused businesses like passenger air transport extends well beyond the carrier to suppliers as a matter of course. "We're highly regulated by the Department of Transportation and the Federal Aviation Administration," says Phung Ngo-Burns, CFO of scheduled and chartered airline, ExpressJet, "and we have an extensive quality control program. We also go out

ABOUT THIS REPORT

In the fall of 2008, CFO Research Services launched a study to examine finance executives' views on risks to the supply chain, with a particular focus on the physical hazards (including natural and man-made disasters) that can affect companies' supply chains and disrupt their businesses.

We conducted a series of eight in-depth interviews with senior finance executives at leading U.S. companies for this research program; this piece is one in a series of three essays that report the results of these conversations. We also conducted a survey for this study, gathering 169 responses from senior finance executives at large U.S. companies. Complete survey results are available in *Physical Risks to the Supply Chain: The View from Finance*, available at www.cforesearch.com.

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to our [potential supplier's] facilities and perform audits, and make sure that they pass those audits.... Until they pass those quality controls, we will not work with a supplier, because our [aircraft] operating certificate is very valuable to us." Ms. Burns continues, "Since we're regulated, we have to have [operating] risk management in place automatically. In the transportation industry, you have to do it, or you don't operate."

Engineering services and construction company CB&I Lummus designs and builds highly complex hydrocarbon processing facilities around the world. To carry out its work, the company sources extremely complex, highly engineered components from an exclusive group of suppliers around the world. "The companies that CB&I Lummus works with in partnership are typically a very select group of companies. They're people that are in the same business.... The company tends to protect itself by working with these well-known, reputable people," says former vice president and controller Mike Ford. The finance executives we interviewed make a strong case for including a reputation for excellence among its selection criteria when choosing suppliers.

Put it in writing

The finance executives we spoke with agree that companies in general make good use of risk transfer instruments like insurance to protect against supply-chain disruption. The problem, they say, is that many risks simply aren't transferable—at least not at a reasonable cost. When they're crafted well, the contractual agreements that form the foundation of business relationships contemplate these risks and prepare for them. "When we enter into a relationship with a major supplier, there is a master agreement we enter into to make sure we're protected.... We do ask for insurance limits. We ask about their disaster recovery program and [provide for] indemnification, and so on," says Phung Ngo-Burns. Incorporating disaster recovery provisions, specifying risk transfer expectations, and providing for indemnity in case of unexpected disruption are all good practices that serve companies well. At the same time, the finance executives we spoke with point out that contractual indemnity for losses due to supply-chain disruption rarely covers the full scope of those losses. Rather than relying on indemnity clauses alone to mitigate the risk of disruption, finance executives note that it's often worthwhile to plan for—and specify—alternative supply in case of disruption.

Trust, but verify

The global economic downturn has spurred many companies to evaluate—and re-evaluate—their key suppliers' financial stability. Some finance executives suggest that companies should extend this review and reflection to include important dimensions of key suppliers' operating performance, as well as their financial performance: Do suppliers have a reputation for high standards and operational excellence? Do deliverables consistently meet specifications? Are items stored properly and protected from damage prior to delivery? Are vendors' facilities safe and secure? Getting answers to these and other questions will probably require in-person visits, according to our sources. Indeed, nearly all of our sources in this program—highly sophisticated manufacturers with complex and demanding sourcing arrangements—place resources on site at key suppliers' facilities. "CB&I Lummus normally places inspectors and expeditors in all of the major shops where orders have been placed," says Mr. Ford. "The company has a staff that will go into manufacturers' plants, inspect the goods as they're being manufactured, and monitor their progress." The divisional CFO of a leading global electronics manufacturer says, "We tend to keep our own people in a lot of our supplier locations. We're pretty aware of what's going on in our supply operations." Oversight, in other words, not only adds visibility, but also helps to build trust between supply-chain partners.

If suppliers clear financial hurdles but fall short on operational standards, companies that are placing orders in this competitive business environment may find themselves with the leverage to negotiate for better performance and greater oversight—and more of a reason than ever to build relationships with suppliers who can deliver. As Rob BonGiovanni, former CFO of Curtiss-Wright Flow Control says, "Certainly, before we even select a supplier, there are certain criteria [in addition to price and other commercial terms] that have to be met. In some instances, we actually visit and do walks of their plant. We look at their processes and see if they meet our standards. Because at the end of the day, suppliers represent us: that final product is a Curtiss-Wright product—not Supplier A's product."

—CELINA ROGERS AND JANE COULTER, CFO RESEARCH SERVICES

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