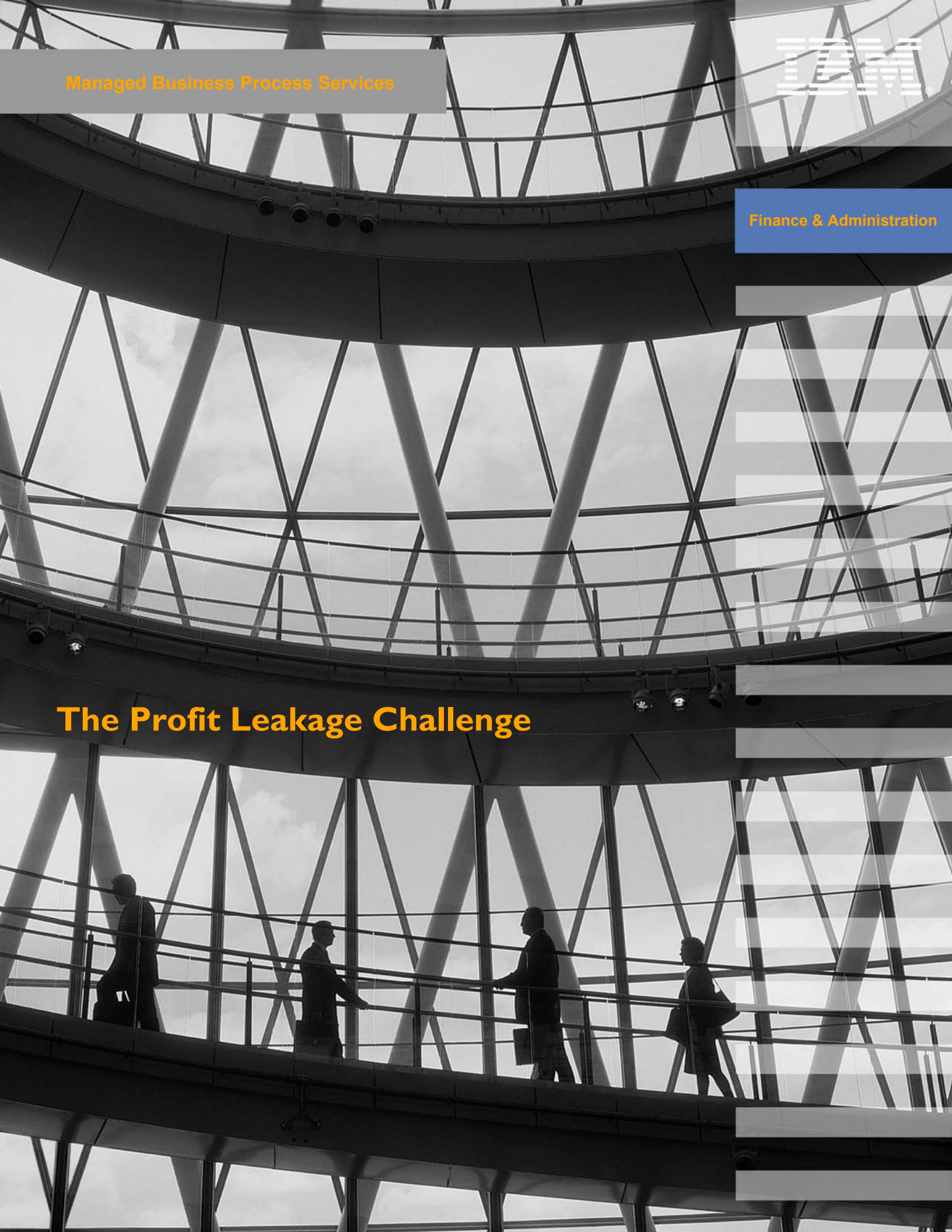


Managed Business Process Services



Finance & Administration

The Profit Leakage Challenge





The profit leakage challenge

There's a stealth loss of profits in most consumer products companies today – and a sizeable loss at that, ranging from a whopping 4 to 7 percent of revenues. That is a significant portion of the total trade promotion spend and related chargebacks and deductions, which on average range between 10 to 20 percent of revenues. When manufacturers find short payments on invoices or excessive discounts taken due to disputes or discrepancies, these deductions subtly siphon away profits.

According to the Credit Research Foundation, 59 percent of

companies allow (credit or write off) between 70 and 100 percent of total deductions after investigation, because they either believe a large portion of these deductions are 'authorized' by trade promotion agreements or they don't have the visibility to resolve quickly. However, about one-third of these deductions are actually 'avoidable' and largely undetected – until someone astute uncovers the situation or it aggregates to a major problem.

Today, IBM's state-of-the-art, proprietary processes, technology, and expertise are designed to eliminate between 20 and 35 percent of total 'avoidable' deductions, which translates into potential improvements in pretax income of 1.0 to 3.0 percent of revenue for suppliers.

Suppliers typically don't capture enough granular data in their Order-to-Cash (O2C) cycle to make headway against deductions –or they can't access the data easily and effectively.

Further, they lack the requisite dedicated staff in operations and systems, have not measured the extent of the problem to size the profit leakage opportunity or they simply don't know what steps to take to attack the problem.

What is profit leakage?

Deductions play a significant role in retailers' financial performance. They operate on very slim margins, with pretax earnings generally between 1.5 and 2.5 percent of revenues. Capturing a 2 percent cash discount could make the difference between reporting a profit or loss for the retailer.

Deductions can decrease product acquisition costs, offset overhead, reduce advertising expenses and lower distribution costs, just to cite a few reasons why retailers manage them so persistently.

Suppliers have several challenges in detecting and managing deductions. Proper accounting

expense recognition can make it difficult to aggregate deductions in a discernable manner on a timely basis. Since significant attention has been dedicated to resolving 'authorized' trade promotion - related deductions, many companies are missing the opportunity to drive more volume on the top line or significant margin improvement on the bottom line by eliminating 'avoidable' type deductions.

Viewing the individual amounts as immaterial, suppliers write off many 'avoidable' deductions, rather than incur additional expense in manually researching the disputes to the root cause, negotiating settlements, and changing the policy or practice to eliminate the reoccurrence of such deduction.

Suppliers often cannot keep pace with the significant volume of deductions and chargebacks taken



by their customer, let alone research the disputes and react in a timely manner. This is caused by:

- Lack of automation and investment in systems to address the deduction management process in volume.
- Deductions against individual line-items are difficult to track and/or process because of the lack of granular detail available in most A/R systems.
- Suppliers lack strong visibility into O2C processes, making it difficult to understand/ manage variability caused by different customers, products, warehouses, etc.
- Suppliers' processes and procedures typically do not have root-cause research capabilities to continually identify/ eradicate the source of recurring issues.
- Often suppliers cannot contest issues due to the extended period of time required to

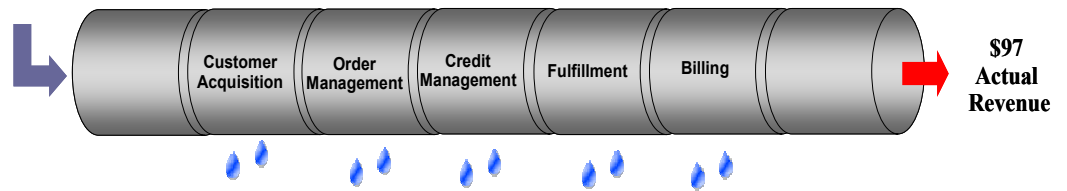
complete the research. This is typically due to a lack of clarity around internal responsibility and poor discipline.

As a result, improper deductions can occur for extended periods of time – piling up millions in losses – because the staff is unable to rapidly identify and raise issues. This is what is referred to as 'profit leakage'.

Lines of accountability are unclear, and information needed to resolve disputes is not easily obtained. Transaction processing costs are thus transferred from the retailer to the supplier, as deduction resolution typically is very labor intensive.

Disharmony in the customer relationship develops with each side frustrated with the other. Further, recent business scandals have raised questions and focused attention on the earnings quality of heavy users of trade promotion deductions.

\$100 Potential Revenue



REVENUE / PROFIT LEAKAGE

ROOT CAUSES				
<p><u>Pricing Errors/ Discrepancies</u></p> <ul style="list-style-type: none"> >Disparity from agreed upon prices >Prices reconciliation issues (i.e., 2-way match) >Inaccurate price maintenance by either party >Variations in units of measure invoiced 	<p><u>Returns & Reclamations</u></p> <ul style="list-style-type: none"> >Limited data available from reclamation centers >Returns policy not enforced >Sales practices the produce excess returns >New products generate obsolete / old product returns 	<p><u>Shortages</u></p> <ul style="list-style-type: none"> >Lack of visibility of concealed shortages >Carrier loss or damage of products in-transit >Pick, pack & ship process errors >Quantity / unit of measure (UOM) discrepancies 	<p><u>Incorrect Terms</u></p> <ul style="list-style-type: none"> >No systematic checking of credit terms during order creation >Changes to credit terms missed >Invoices issued prior to receipt of POP >Extended payment timeframes driven by sales team 	<p><u>Advertising & Promotions</u></p> <ul style="list-style-type: none"> >Vendor agreements & promotional contracts not readily available across organization >Proof-of-performance (POP) required from sales team >Inability to detect errors / duplicates timely



Unmatched value creation

Deductions can be categorized in two broad types: 'authorized', which are typically driven by trade promotions, and 'avoidable', which can result from either the supplier's or the customer's actions.

Advertising and promotion deductions

Advertising and promotion deductions as a rule are anticipated and authorized, rather than the result of a dispute or discrepancy. Between 50 and 70 percent of total deductions and chargebacks between suppliers and retail customers are permitted by trade promotion agreements. Such 'authorized' deductions include discounts, rebates, markdowns, allowances, co-op advertising and other promotions. Here, the 'profit leakage' stems from the supplier's inability to clear legitimate deductions quickly to discover errors or duplicates without delay.

The longer such discrepancies remain undetected, the higher the chances that the dispute will be negotiated or that the retailer will become unhappy with the timing of the repayment and its financial effects. Documentation and communication of agreements often are not sufficiently detailed, updated timely or easily accessible. In addition, many suppliers have difficulty managing trade-promotion budgets and allowances because of vast inconsistencies in policy across the customer base.

Unsaleable product and reclamation chargebacks

Unsaleable product and reclamation chargebacks are frequently employed by retailers to their advantage, some forcing such deductions to zero cost. Suppliers are largely unprotected due to unenforceable policies and low visibility, until materiality hits the profit and loss statement.

Additionally, most manufacturers lack sufficiently detailed reporting capabilities to challenge the basis of the deduction.

Pricing discrepancies

Pricing discrepancies are the root cause of several profit leaks. Disparity from agreed-upon prices, if for high-volume, low-cost items, is generally written off, trickling out cash.

Profits also leak when the retailer's invoice matching process detects a price reconciliation issue, resulting in delayed payment and/or a charge for administrative costs. Or, some retailers will pay short after matching the purchase order and receiving report, transferring the reconciliation process to the supplier.

Fines and penalties

Fines and penalties due to contract compliance violations often initially slip through undetected, written off until an expense line exceeds budget. Examples of violations might include early or late deliveries, logistics infractions, ASN/EDI problems, UPC errors and improper handling of product returns.



Again, researching a dispute is very labor intensive, costly and often inaccurate, because those involved are not well acquainted with all contract details, side agreements and facts. A belated response to the customer becomes ineffective, because of timeliness, cost and the risk to future sales volumes by taking an adversarial posture.

Moreover, the supplier's cost to comply with a retailer's requirements may be prohibitive, engendering penalties. Likewise, a supplier's processes and procedures, intended for efficiency, may often conflict with terms in the supplier agreement and bring about unintended fines. In many companies, there is a lack of accountability for fines and penalties, which are lumped as "other" expense line items.

Over and short shipments

Over and short shipments occur for a variety of reasons: pick, pack and/or ship mistakes, transportation errors, receiving missteps, documentation lapses or product file inaccuracies.

Genuine shortage deductions are among the most collectible, if pursued in a timely manner, since they can be clearly documented. 'Profit leakage' principally occurs because of a supplier's inability to respond within a carrier's required time frame, normally nine months.

Suppliers usually miss this deadline due to lack of aggregated visibility of the low dollar value and high volume of such deductions. The issue for suppliers is prioritization.

Other types of over and short shipment deductions result from process errors in the pick, pack

and/or ship functions, which, if accurately identified, can be corrected, eliminating the root cause.

Deductions developing during the retailer's receiving process can be reduced, if not eliminated, if addressed quickly in a collaborative manner. Disputed product information, such as case quantities, will cause deductions at an alarming rate in either supplier or retailer systems.

Quantity/unit of measure (UOM) discrepancies

Quantity / unit of measure (UOM) discrepancies also cause over and short shipments as a direct result of picking problems in logistics. The wrong unit of measure is used to pick an item. Billing discrepancies can hide the leakage; for example, an order placed as an "each", is picked and shipped as a "two-pack", a greater volume than what was billed.

On the flip side, a similar error could occur by picking and shipping an "each", when a pack or larger UOM was ordered. Quantity discrepancies can be detected by establishing the standard weight of each product by unit of measure, recording the weight of products shipped and checking for reasonableness before shipping.



How to address profit leakage

- Suppliers typically don't capture enough granular data in their Order-to-Cash (O2C) cycle to make headway against deductions – or they can't access the data easily and effectively. Further, they lack the requisite dedicated staff in operations and systems, have not measured the extent of the problem to size the 'profit leakage' opportunity or simply don't know what steps to take to attack the problem. As a result, companies are seeking alternative solutions that address the 'profit leakage' challenge.
- Outsourcing O2C processes to IBM offers suppliers an alternative that enables collaboration across the customer related processes. Our turnkey state-of-the-art proprietary solutions offer the supplier dedicated people, process, technology, and transformation capabilities to optimize the O2C cycle from end-to-end, specifically designed to reduce 'profit leakage'. Manual activities are automated, with highly structured, rules-based workflow techniques to maximize efficiency at a line item detail level. A management platform for Six Sigma quality initiatives forces clear lines of accountability across the enterprise and provides granular, actionable information to target behavioral change at the source of the issues. IBM's industry-specific, state-of-the-art processes have been customized to address specific 'profit leakage' issues across suppliers in consumer industries. Our highly flexible process and technology platform essentially 'wraps around' the supplier's existing systems and offers a speedy implementation to the 'profit leakage' challenge, which translates into potential improvements in pretax income of 1.0 to 3.5 percent of revenues.
- The outcome is clean, repeatable transactions between suppliers and their retail customers, reinforced by clear and rapid paths for problem identification and resolution, all designed to stop the erosion of profits from deductions and chargebacks. The resulting increased efficiency will also free up available resources to provide better customer analysis, resulting in customer and market intelligence that can offset potential negative trends and impact the top line.
- Do you know how much 'profit leakage' costs your organization? Are you being pressed to identify value-generation opportunities beyond just headcount efficiency improvements? Assessing your potential opportunity to deliver these far-reaching financial and operational benefits can draw focus to this untapped margin enhancer. It can be the trigger that brings to your organization the much needed focus to manage Order-to-Cash on an end-to-end basis.

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