MANAGING THIRD PARTY RISK

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Our Time Today

• Third-Party Relationships – Current Trends
• Phases of Each Relationship
  – Evaluate Options
  – Negotiate Agreement
  – Monitor Service Level Performance
• Internal Audit Focal Points – How to Add Value to Your Organization
Recent Trends

• **42%** of companies now describe themselves as highly vulnerable to vendor, supplier, or procurement fraud
  - *Kroll Global Fraud Survey*

• Also, a recent survey indicates that **85%** of companies recently suffered at least one supply chain disruption
  – *Zurich Financial Survey*

• In 2012, **90%** of all FCPA cases involved third-party intermediaries – organizations need to evaluate their understanding of and compliance with statutes such as the FCPA and UK Bribery Act.
  - *Corporate Executive Board – February 2013*
2013 Viewpoint

There is a renewed focus within IA Departments to identify new areas to add value to their organization and repriortitize risks

Top 11 Risks for CAE’s and IA Directors in 2013:
• #2 – Operational Risk – Third Party Relationships
• #9 – Information Risk – Third Party Relationships

-2013 Pulse of Internal Audit CEB
2013 Viewpoint

THIRD-PARTY RELATIONSHIPS INCREASING

Companies are increasingly relying on a complex ecosystem of (global) third parties for critical business services. While achieving cost reductions and lower working capital levels, firms have increased their financial, operational, compliance, and reputational risk exposures through these arrangements. In response, companies should re-evaluate their operating models to ensure an appropriate balance between efficiency gains and the effective management of these third-party risks.

-CEB 2013 Audit Plan Hot Spots
2013 Viewpoint

CAE Perspective:

Last year, almost 55% of CAEs identified control deficiencies in third-party relationships, perhaps not surprising given the growing eco-system of third parties to execute core business functions, most specifically contract workers and outsourcing service providers. In addition, ongoing macroeconomic woes and commodity price volatility have increased the risk of severe supply chain disruptions.

- CEB 2013 Audit Plan Hot Spots
2013 Viewpoint

Bangladesh Incidents
– 112 people killed in a November Fire
-- 700 people killed in April building collapse

Result: Many companies assessing their supply chains in Bangladesh

Walt Disney Company was already in the process of phasing out production in the country when the April incident happened

- CEB May 7, 2013 Daily Update
2013 Viewpoint – IA Response

Assess the due diligence processes that occur before and on renewal of 3rd party agreements, validating that ethical sourcing standards are incorporated to minimize the chance of corporate brand damage.

Example questions to ask include whether companies recognize unions, and whether they can trace raw materials to their point of origin. Environmental, health and safety conditions are not the only risks--recognize that 90% of Foreign Corrupt Practices Act (FCPA) violations involve a third party or subsidiary, so include a right-to-audit clause in all contracts.

- CEB May 7, 2013 Daily Update
Cadbury-Schweppes New Supplier Pre-Qualification Questionnaire

Applied to all new suppliers, includes extensive questioning around ethical sourcing standards, in addition to standard selection screens such as operational capabilities and financial information.

**Suggestion:** Divide questions around ethical sourcing standards into categories such as environment, health and safety, human rights and ethical trading, sustainable development, and bribery and corruption.

- CEB May 7, 2013 Daily Update
NSA Consultant

• 30 year old Booz Allen Consultant on NSA engagement in May 2013
• Had spent less than 3 months with Booz Allen at the time of the incident
• Accused of espionage after leaking documents about a secret NSA surveillance
• Former CIA and NSA Employee
• Described as the most significant leak in US history
• Differing views of the individual
Alleged Navy Shipyard Gunman

- 34 yr. old Military Contractor from Texas
- The Washington Naval Shipyard reportedly has over 3,000 civilian, military and contract support personnel working in the building attacked by the gunman this past Monday
- Location of shooting described as a “highly secure” military site
- Lapses suggested in security screening and Base protection, subsequent to the event
- Arrested in 2004 for shooting out tires of a car
- Security clearance granted in 2008
- Reported history of mental illness
Talent Trends – Why Companies Leverage External Resources
Percentage of U.S. employers having difficulty finding talent

![Graph showing percentage difficulty finding talent from 2006 to 2011 for U.S. and Global. The trend shows a decrease from 44% in 2006 to 14% in 2010, followed by a sharp increase to 52% in 2011.]
The working age population is shrinking

To sustain economic growth, by 2030 the U.S. will need to add more than 25 million workers.

*World Economic Forum*
By 2020, there will be 123 million high-skill, high-pay jobs available in the U.S., but only 50 million Americans with the right education to fill them.

Economist Intelligence Unit
Workplace Balance

Cut costs
Increase flexibility
Enhance innovation

Knowledge management
Engage
Increase productivity
There’s a lot of money involved!

- 95% of organizations buy or provide outsourcing services
- Two Thirds of organizations spend upwards of 50% of their budgets on outsourcing
2012 Global Outsourcing Market for BPO and IT Services Exceeded $300 billion
U.S. Government annually spends $550 billion on outsourced products and services
Boeing 787 Dreamliner
A complex, integrated, interconnected environment

Supply chain issues + new technology + new approach = problems

- Made of entirely new composite material
- 6,000 engineers
- 43 “top tier” suppliers on 3 continents
- 80% of production outsourced
- Exacting technological demands
- Overly ambitious production deadlines
The result?

- Plane delayed by 2+ years
- Upwards of $6 billion in lost profits
- Millions in contract penalties for late delivery
- Reputation took a “hit”
Top 5 Reasons Organizations Outsource

- **75%** Reduce and control operating costs
- **65%** Focus on core competencies
- **59%** Resources not available internally
- **52%** Reduce internal headcount
- **51%** Reallocate internal resources for higher value purposes
Top 5 Functions Outsourced

- IT (all categories): 69%
- Operations and administration: 29%
- Customer service: 26%
- Other (wide variety): 21%
- Financial (payroll, etc.): 20%
Phases of Each Relationship
Phases of Each Relationship

Evaluate Options

Negotiate Agreement

Monitor Service Level Performance
Evaluate Options

- Procurement Process
- RFI, RFP, Proposals, SOW’s
- Bid Submittal Process
- Transparent Bid Opening Process & Controls
- Selection Criteria
- Due Diligence
- Final Decision Documented?
Due Diligence Review

- Audited Financial Statements
- Experience & Capabilities
- Business Reputation
- Qualifications & Experience
- Existence of significant complaints, litigation or regulatory actions
- Use of other parties or subcontractors
- Scope of internal controls, systems, data security and audit coverage
- Business resumption strategy & contingency plans
- Adequacy of management information systems
- Insurance Coverage
7 Steps to “Better” Third-Party Relationships

1. Conduct market research and “ask around”
2. Widely distribute your RFP/Bid/Tender
3. Have strong evaluation criteria and an experienced proposal review team
4. Google / Facebook “key personnel” offered
5. Perform due diligence on technical and financial capabilities to perform
6. Demand a demonstration
7. Meet the key executives
Negotiate Agreement – Questions to Ask

- Centralized?
- Trained Negotiators?
- Legal Department ALWAYS Involved?
- Delegation of Authority Verified PRIOR to Execution?
- Contract Repository?
- Access to Repository Limited?
Content of the Contract

- Scope
- Cost/Compensation
- Business Reputation
- Performance Standards/SLA’s
- Management Information Reports
- Right to Audit
- Confidentiality & Security
- Business Resumption and Contingency Plans
- Default & Termination
- Dispute Resolution
- Indemnification
Contract Structuring & Review – The Obvious

• Management should ensure that the specific expectations and obligations of both parties are outlined in a written contract prior to entering into the arrangement.

• Board approval should be obtained prior to entering into any significant third-party arrangements.

• Legal counsel should review significant contracts prior to finalization.
Oversight of Third-Party Activities

• Management should periodically review the Third party’s operations to verify that they are consistent with the terms of the written agreement and that risks are being controlled.

• Management should consider designating a specific officer to coordinate the oversight activities with respect to significant relationships and, as necessary, involve other operational areas (audit, IT) in the monitoring process.

• An effective oversight program will generally include the monitoring of the third party’s quality of service, risk management practices, applicable internal controls and reports.
Monitor Performance – Questions to Ask

• Monitoring adherence to the agreement – Who performs?

• Annual scoring of performance – Are there documented performance statistics for each vendor where appropriate? Who scores?

• Renewal process – How is it coordinated between procurement and process owners?
Internal Audit Focal Points – How to Add Value to Your Organization
Focal Points for IA:

- **Transparency** – a must from start to finish with each vendor!
  - Hotline Reporting Number on RFP’s?

- **Consistency** – centralized or decentralized environment?

- **Control Environment** - strong or weak?

- Evaluate the process of monitoring vendor performance
Gaming the System, Ethical Dilemmas & Fraud

- Inflated “Rack Rates” vs. final “Negotiated Rates” – increased annual bonus tied to cost savings
- CFO Request – split into separate SOW’s to prevent Board Approval
- Inappropriate Relationships -- $25 million telecomm cabling contract & dual invoicing
- International Locations – further from the Corporate Office, the likelihood for fraud increases.
Risk Focal Points

• FCPA & UK Bribery Act Compliance – payments made through 3rd Parties – numerous recent FCPA fines related to bribes made through third parties

• Right to Audit Clause

• Financial Stability

• Sole Source Providers

• Background and Drug Screening
Risk Focal Points

• PC & Internet access – start & finish of project

• Equipment and Badges – monitoring them

• Building Access – too liberal?

• Data Access and Retention Policies – do vendors comply?
Validation - Risks Involved – CEB View

**Reputation Risk:** Where third-party activities do not conform to the expectations of an organization’s stakeholders, their behavior can be the source of reputational issues.

**Poor or Inconsistent Quality:** Relentless focus on being the low-cost provider can negatively impact third-party business operations, resulting in reduced quality of goods and services.

**Data Access Risks:** As larger numbers of contractors and contingent workers conduct work through organizational IT networks, they may receive too many system access rights, exposing intellectual property and sensitive client or customer information.

**Compliance Risk:** Third-party noncompliance with regulatory requirements and ethical standards could result in significant fines and reputational damage.

- *CEB 2013 Audit Plan Hot Spots*
2013 Audit Plan Additions?

**Third-Party Governance Review:** Ensure internal procedures regarding the use of third parties are comprehensive and consistently applied. These should cover processes, such as due diligence, contract management, and relationship termination.

**Audit Rights Review:** Look through contracts to see whether audit rights are included over third-party vendors. As contracts are renegotiated and new relationships are formed, ensure a right to audit clause is included.

**Due Diligence in Selecting Third-Party Relationships:** Assess the due diligence process used to select vendors and other partners, including an examination of the third parties’ internal control environment, security history, legal compliance (including complaints, litigation, and regulatory actions), and financial status.

**Supply Chain Management Health Check:** Review whether risk management is appropriately integrated into supply chain management—cutting across individual parts, such as procurement, logistics and distribution—and includes a focus on lower likelihood but higher impact risks, such as business continuity, currency crises, and commodity volatility.

- CEB 2013 Audit Plan Hot Spots
Further Validation

*What are the most important new developments that auditors should be aware of when evaluating the effectiveness of third-party relationship management?*

- **Stronger Supply Chain Vulnerability**—Since the recession, many companies have switched from local supplier networks to low-cost and often distant suppliers, relying on subcontractors and just-in-time production with minimal inventories. This migration has created a more extended, global supply chain with many additional points of potential failure. Although companies have successfully reduced costs, the vulnerability of these global supply chains has grown in the past few years as a result of disruptive natural disasters and commodity price volatility. Many companies now face more exposure to logistical delays for critical products, contract breaches, and product quality issues.

- **Increased Reliance on Third Parties to Perform Core Business Roles**—Increasingly, third-party relationships are eroding traditional organizational boundaries. For example, 36% of companies rely on contract workers to fulfill business needs, while outsource or insource providers now run entire HR, finance, and IT processes. These external relationships have reduced companies’ immediate legal control and increased exposure to ethics and compliance missteps and potential service failures.

*CEB 2013 Audit Plan Hot Spots*
Further Validation – cont’d

What are the most important new developments that auditors should be aware of when evaluating the effectiveness of third-party relationship management?

• **Intensified Regulatory Focus on Third-Party Relationships** — Regulators across industries are actively scrutinizing third-party relationships in areas such as data privacy, environmental compliance, and corruption and bribery, focusing on the quality of due diligence, training, and continued monitoring by companies. Earlier in 2012, the SEC issued a final rule pursuant to Dodd-Frank Section 1502 on the use of conflict minerals in products, highlighting the potential exposure created through third-party relationships and the need to perform more thorough due diligence.

• **Internal Audit** should ensure the effectiveness of third-party relationship management from initial screening, data collection, and documentation reviews to contract management and ongoing monitoring of third-party risk. Also, internal audit should work with procurement and other groups to evaluate whether risk management has sufficiently been integrated into the supply chain management.

    - CEB 2013 Audit Plan Hot Spots
Resources

CEB Procurement Strategy Council®
Questions?

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