Supplier risk - compliance obligation or source of competitive advantage?

Improve supplier reliability to lift business performance

The better the question. The better the answer. The better the world works.
An unreliable supply chain — whether for materials or services — is an operational nightmare that can literally put a business out of business. When crucial supply deliveries are disrupted, hackers attack a supplier’s IT systems or political turmoil closes down distribution channels, the damage to profits, customer loyalty and brand can be considerable – or even catastrophic. Companies that have lived through a major event have built safety measures into their supplier portfolios, but even those that have not had such an experience still make day-to-day decisions to protect reliability and, in doing so, build costs into their business. Many of today’s companies lack an in-depth quantified understanding of their full investment in managing supplier risks. At one such firm, following several operational and risk reviews, the board registered its agreement with the enterprise risk management team’s assessment: supplier risk and reliability must be actively monitored and measured.

Already under pressure to reduce spending, the chief procurement officer (CPO) was charged with building a risk management function that would both satisfy compliance requirements and save the company money. The CPO embarked on an ambitious initiative: to better understand the risks and uncertainty presented by the company’s suppliers, and thus be better able to analyze explicit and implicit costs required to manage and monitor them. With this knowledge, the company could make more informed decisions about suppliers and how much supplier risk to take on and pay for.

A team from the procurement and risk management functions examined the supply chain’s risk and reliability factors and chose which should be monitored and measured. With detailed financial analysis and analytics, they quantified the inherent and residual risks and the cost of mitigating inherent risks. Scenario planning helped determine which risks the company wanted to retain, manage differently, pass on to the supplier or eliminate. Lastly, the group created a monitoring program to qualify new suppliers, re-examine existing suppliers based on the new criteria, and flag imminent issues. The board was pleased as management could now produce a dashboard that showed quantitative and qualitative measures of supplier risk and volatility, demonstrating how the company was making better decisions regarding cost control.

Steps to reduce supplier uncertainty and uncover cost savings
Managing in a volatile world

A natural disaster in Japan disrupts innumerable manufacturing supply chains around the globe. A safety recall in the US bogs down both wholesale and retail vendors of consumer goods. The measures required to correct these failures cost the affected companies millions of dollars and significant reputational damage.

With supply chains operating far from a company’s direct control, it can be challenging to identify supplier exposures and to understand and mitigate related risks. Potential risks could range from operating in countries where bribery is a pervasive business practice, to inadequate IT security procedures, to sudden changes in suppliers’ manufacturing capabilities.

If companies understood all of the costs incurred to manage supply chain risk and volatility, they would make different decisions about these costs and the way they allocate resources. Risk premiums that are negotiated or embedded in their suppliers’ prices are often excessive.

Often, functions within companies have a siloed understanding of supplier dependability, which leads to non-integrated risk management and inconsistent reporting to executive management and the board. Management need to understand all the elements of risk and unpredictability their suppliers present. Additionally, they need to establish shared principles governing supplier selection, engagement and compliance activities, and the related reporting, that are consistently applied across departments.

The supply chain cost conundrum

Hidden on the bottom line

A company’s manufacturing function, typically most concerned about maintaining uptime, may require suppliers to invest in expanded production capacity exceeding any foreseeable demand. As a result, the company is burdened with higher prices as suppliers amortize their invested capital. Yet these measures, in fact, do nothing to improve risk exposure.

EY’s work with clients and our extensive analysis have shown that supplier risk and reliability management practices for a typical global company can account for as much as 3% to 7% of the organization’s spend, or US$30m to US$70m for every US$1b spent on materials and services. That’s a significant investment that should be monitored and managed by senior management.

Companies need to take a proactive approach to managing risk and optimize investments both in managing uncertainty and monitoring relevant developments. By stepping back and using a more strategic methodology, companies can not only reduce exposure, but also improve business performance.

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Taking charge of supplier risk

When the right questions aren't asked and risk isn't properly managed, companies spend millions of dollars in remediation to stem the negative impact on brand and stock price.

Too often, they approach supplier risk and reliability management in a reactive, fragmented way. Most business areas view supplier management as a risk compliance requirement focused on checking the boxes. Prudent companies, however, find that a holistic approach to managing risk and volatility can also help improve overall performance. They quantify their total risk exposure, which empowers the organization to make better-informed decisions on the most effective investments to minimize uncertainty.

An effective supplier risk and reliability management program can help organizations proactively manage risk profiles, providing increased levels of transparency and visibility into the procurement process. Companies that stay ahead of supplier developments have clearly delineated lines of accountability for managing the associated risk. They have established a framework to quantify risk exposure for supply chain operations across the enterprise.

From compliance to clarity

Measuring supplier risk is far more than a compliance exercise. Here are the steps an organization can take to better manage supplier (and third party) risk.

1. **Assess the supplier risk landscape**
   Complete cross-department assessments that establish shared likelihood scenarios and impact criteria for specific categories of supplier risk events. Identify what supply chain uncertainty the company is willing to assume and incorporate that thinking into risk design plans.

2. **Establish a governance structure that clearly delineates supply chain responsibilities**
   Design a governance structure with clear reporting and escalation lines, providing sponsorship, coordination and strategic direction for the risk management activities, and the ability to make decisions supported by the new level of transparency.

3. **Perform cost-of-risk analysis of suppliers**
   Analyze supplier cost of risk with the objective of gaining a quantitative view of exposure and mitigating activities, to enable optimization of investment and decrease risk exposure.

4. **Launch the supplier monitoring process**
   Perform supplier assessments and gather third-party data in line with the newly established risk assessment principles to obtain qualitative insights regarding how supplier risk or uncertainty is impacting your organization.

5. **Deploy dashboard reporting around supplier developments to enhance decision-making**
   Provide risk scoring and event notifications to management, which will assist in decisions to better mitigate uncertainty, as well as to optimize costs for this mitigation.

In addition to these five steps, you should anticipate the need for enabling tools that can help the organization to better manage supplier reliability. In particular, the marriage of current supplier performance data, news feeds and notifications with supplier-provided data can help the procurement function properly and proactively respond to risk triggers.
Understanding the supplier-risk universe is a starting point for broadening a company’s view. As companies and their suppliers become more connected, there are more opportunities to control costs and provide proper oversight. Companies that move decisively toward coordinated supplier risk and cost control management will have a competitive edge, both in terms of cost control and brand reputation.

Assess, align and activate

Siloed approaches to supplier reliability usually lead to contract governance gaps, overlapping monitoring programs and increased execution costs. Meanwhile, governments around the world are increasing enforcement of regulations relating to supplier risk. As pressures mount on costs and compliance, margins are squeezed and industry competition intensifies. So now is the time to take a proactive approach to managing the risk and to optimize investments in both managing uncertainty and monitoring relevant developments.

The supplier risk universe encompasses multiple dimensions and stakeholders

<table>
<thead>
<tr>
<th>CFO</th>
<th>COO/supply chain</th>
<th>CIO</th>
<th>CPO</th>
<th>ERM/internal audit</th>
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<td>Operational risk</td>
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<td>Continuity</td>
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<td>Supply availability</td>
<td>Delivery</td>
<td>Intellectual property theft</td>
<td>Commodity price volatility</td>
<td>Corruption (FCPA(^1), bribery)</td>
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<td>Supply disruption, unplanned obsolescence</td>
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<tr>
<td>Supplier failure</td>
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<td>Wage inflation</td>
<td>Accountability and transparency (SOX, EPA, FERC, API(^2))</td>
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<td>Product/support discontinuation</td>
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<td>Personal theft data violations</td>
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<td>Contract non-compliance</td>
<td>Workplace practices (Labor, HS&amp;E(^4))</td>
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<tr>
<td>Geopolitical</td>
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<td>Supplier’s market risk (passed through pricing)</td>
<td>Local government regulations/tax</td>
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\(^1\) Foreign Corrupt Practices Act  
\(^2\) Sarbanes-Oxley Act, Environmental Protection Agency, Federal Energy Regulatory Commission, Accountable Property Inventory  
\(^3\) Office of Foreign Assets Control  
\(^4\) Health, Safety & Environmental Compliance
Supplier transparency strengthens compliance

Challenge and EY role
An international company had planned an acquisition that would double its supplier base. The company engaged EY to perform a current state assessment of its supplier risk management program and to develop an integrated risk-scoring and monitoring model that would support the company’s future operations. The engagement entailed benchmarking the client’s processes with supplier risk management leading practices, developing a comprehensive supplier risk management process overview, and developing high-level cost of risk estimates for priority categories.

Value delivered
- A single transparent approach now exists for managing supplier risk across the organization with the appropriate governance to support long-term sustainability.
- The enterprise is better positioned to effectively and consistently evaluate the risks of both existing suppliers and those introduced through the acquisition.
- The program, once fully implemented, will strengthen the company’s compliance with regulations around the supply base.
- The company identified instances where the cost of managing supplier risk did not align with the potential overall risk to the organization. Aligning supplier risks and investment to monitor those risks will reduce the overall likelihood of the risk occurring and lead to potential cost savings.

Managing risk in a growing supplier base

Challenge and EY role
A global company’s supplier base was growing faster than the business. EY was engaged in a program jointly sponsored by the risk management and procurement functions to assist the client in developing a more robust risk management process for new suppliers, given the possibility of increased reputational risk to the company. EY worked with the organization to identify and prioritize key supplier risks and to help develop and implement a process for evaluating those risks during the supplier vetting and acceptance process.

Value delivered
- An improved approach now exists for considering an expanded set of risks when taking on new suppliers.
- A new, robust questionnaire provides data points for buyers when making decisions on new suppliers, as well as additional leverage during negotiations.
- The company has a foundation for further expanding the program across the existing supplier base.
- Potential cost reduction opportunities may result by better aligning the cost of managing supplier risk with the areas of greatest risk.
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