Third-party risk: Moving from a compliance obligation to a source of competitive advantage

Improve third-party reliability to lift business performance

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Improve third-party reliability to lift business performance

Third party: Any external entity that can materially impact your ability to operate, whether it be a traditional supplier, key opinion leader or sales enablement (e.g., distributors)

An unreliable third party – whether for materials or services – is an operational nightmare that can literally put a company out of business. When crucial global supply deliveries are disrupted, hackers breach a firm’s IT system and millions of individuals’ private data is threatened or a distribution channel loses its Drug Enforcement Administration (DEA) license due to a third party’s role in counterfeiting, the damage to profits, customer loyalty and brand can be significant or even catastrophic. Within the life sciences industry, the criticality of maintaining an effective third-party network is even more important. A disruption to the network will not only affect the bottom line, but could threaten individuals’ lives. Many of today’s companies lack an in-depth, quantified understanding of their full investment in managing supplier risks.

At one such business, following several operational and risk reviews, the board registered its agreement with the enterprise risk management team’s assessment that 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 the company’s suppliers present, and then be better able to analyze explicit and implicit costs required to manage and monitor those risks and uncertainties. With this knowledge, the company would make more informed decisions about suppliers and how much supplier risk to take on and pay for.

A team from Procurement and Risk Management examined the third-party network’s risks 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 what risks the company wanted to retain, manage differently, pass on to the third party or eliminate. Lastly, the group created a monitoring program to qualify new third-party providers, re-examine existing third parties 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.

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Third-party due diligence strategies mitigate a large third-party network

Challenge and EY role

A major pharmaceutical manufacturer’s current vendor onboarding and due diligence process was not consistent or scalable to support a growing business across 50+ markets. EY was engaged to simplify how the company interacted with their third-party network in the process and provide improvements in the ability to manage network rationalization with improved data. EY worked to implement a new third-party due diligence system to pilot on a subset of providers before rolling out the strategy in a pilot form for the company’s hundreds of external vendors.

Benefits realized

- A current-state assessment of the due diligence activities was completed, resulting in the need to address upstream vendor initiation and the master data rationalization process during the future-state process design.
- An initial vendor cleanse and risk assessment was performed for all existing SAP suppliers, and reviews were executed for a portion of high-risk third parties.
- A third-party due diligence and vendor onboarding tool was launched through the implementation of an SAP Ariba module into the pilot market of third-party vendors.
- A consistent, scalable third-party onboarding process was used as a core competency for the global strategic sourcing function and improved the ability to analyze and leverage the third-party network.
Managing in a volatile world

In a globalized business environment, no company is an island. Companies are increasingly becoming more reliant on third parties, ranging from traditional third parties, to sales and distribution support, and even indirectly paid resources (e.g., contingent labor managed through a vendor-managed service). This extended enterprise creates a more complex ecosystem, along with an evolving set of third-party risks that need to be identified and managed in a strategic manner.

A fine of hundreds of millions of dollars is levied by the Food & Drug Administration (FDA) for a violation of Current Good Manufacturing Practices (CGMPs). Disparate ordering systems cause a wholesaler to lose the ability to distribute controlled substances from certain distribution centers for multiple years. An adulterated stock of a key active pharmaceutical ingredient (API) results in a recall and the death of 50+ people. The measures required to correct these failures not only cost the affected companies millions of dollars, but also result in significant reputational damage.

Third-party risk management is further complicated by the fact that it requires cross-functional engagement, including operations, quality, compliance, procurement, legal and finance. Risk efforts are too often focused on responding to events after they occur and are often looked at in functional silos.

With third-party networks operating far from a company’s direct control, it can be challenging to identify potential network exposures, and to understand and mitigate the related risks. If companies understood all of the costs incurred to manage third-party risk and volatility, they would make different decisions about these costs and how they allocate resources. Risk premiums that are either negotiated or embedded in their third parties’ prices are often excessive.

With the recent market quality concerns, prevalent M&A activity, high government scrutiny and growing transparency across the industry, organizations need an enterprise-wide effort to plan for and mitigate the various risks. The life sciences industry is learning to manage in a world that is moving faster, to succeed with frequent disruptions, and to grow, even with increased accountability to customers, shareholders and regulators. However, even more so, the life sciences industry is beginning to understand the criticality of the third-party management space and identify how managing a third-party network effectively can impact the bottom line.
The third-party cost conundrum

Hidden in the bottom line

While managing third-party risk is not new, the urgency to mature the capability has increased. Among the drivers are the growing regulatory requirements that hold companies responsible for the actions of your third parties (i.e., you can outsource the task, but you cannot outsource the risk). Also, extended networks and outsourcing have resulted in lost operational visibility, while in parallel, the accelerated rate at which negative news travels puts brands and reputations at risk. All signs show these trends are only intensifying making the need for a holistic third-party risk management program enabled with integrated technology, market intelligence and focused resources more necessary.

EY’s work with clients and our extensive analysis has shown that third-party risk management practices across industries can account for as much as 3%–7% of the organization’s spend. This equates to an estimated USD $30-$70m for every $1b spent on materials and services. This cost arises from a variety of factors, but includes increased insurance, money spent to hedge against potential spot risks, inflated on-hand inventory, and additional warranties and inspections that come with a segmented risk management approach. That’s a significant investment that should be monitored and managed by senior management.

The focus is on improved outcomes; basic alerting is not enough. The solution must screen out false positives and provide contextualized remediation insights to allow for thoughtful management decisions. By involving third-party risk management within key functional areas in an organization, it allows firms to optimize investments and supplement where there are gaps with analytics, enabling technology and managed services. Proactive change management needs to be embedded in programs to drive early engagement, readiness and adoption. These principles must be utilized, as well as adjusted based on the circumstances, in order for a framework to be effective. Oftentimes, organizations lack the ability to connect the costs necessary to manage third-party risk. EY has created an offering called Outsight that focuses on incorporating key client inputs, the EY infrastructure and capabilities, and relevant market data to support these key client issues (see Figure 1). Companies need to take a proactive approach to managing risk and optimizing investments by both 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 third-party risk

In a survey of 110 life sciences chief supply chain officers, 1 70% of them indicated the need to improve their existing processes or add capabilities when it comes to risk management.

When the right questions are not asked and risk is not properly managed, companies spend millions of dollars in remediation to stem the negative impact on operating costs, brand and stock price. Too often, they approach third-party risk management in a reactive, fragmented way. Most business areas view third-party management as a risk compliance requirement focused on checking the boxes.

However, managing third-party risk is inherently complex and includes stakeholders with different needs, and not necessarily part of the same business function or group. Additionally, it requires information from multiple systems and processes and necessitates results-oriented and tangible approaches by the regulators.

Prudent companies, however, find that a holistic approach to managing risk and volatility can also help improve overall performance. These companies quantify their total risk exposure, empowering the organization to make better-informed decisions on the most productive investments and minimize uncertainty.

Oftentimes, due to lack of visibility and coordinated controls, contract manufacturing organizations (CMOs) and contract research organizations (CROs) pose a growing third party risk to life sciences organizations and require a coordinated, comprehensive effort to ensure the risks are being actively managed and reported. (see Figure 2). Efforts to manage this risk could range from periodic health checks to a managed service responsible for monitoring compliance to help realize the value of the relationship.

While effective third party management requires active involvement across functions, procurement strategically sits at the crossroads of third-party evaluations, onboarding and ongoing management, thus making it a natural coordinator and process owner. No other function in the organization is better positioned to understand broader business needs and to embed the required risk management activities into the sourcing, screening, contracting, onboarding, monitoring and issue management business processes needed to enable early risk visibility and resiliency.

CMOs and CROs pose a growing third-party risk to life sciences organizations and require a coordinated, comprehensive effort to ensure the risks are being actively managed and reported.

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**Figure 2**

<table>
<thead>
<tr>
<th>EY CMO and CRO vendor governance framework</th>
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<tbody>
<tr>
<td><strong>Performance management</strong></td>
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<tr>
<td>- Service-level agreement and reporting</td>
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<td>- GMP scorecard and dashboard development</td>
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<tr>
<td>- Performance analysis and assessment</td>
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<td><strong>Project management</strong></td>
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<tr>
<td>- Program and project administrative support</td>
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<td>- Program status management</td>
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<tr>
<td>- Initiative timing and recommendations</td>
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<tr>
<td>- Transitions and transformation support</td>
</tr>
</tbody>
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1 Aberdeen Group – March 2012 study of 110 chief supply chain officers
An effective third-party risk management program can help organizations proactively manage risk profiles, providing increased levels of transparency and visibility. Companies that stay ahead of third-party developments have clearly delineated lines of accountability for managing the associated risk. They have established a framework to quantify risk exposure across key areas of the enterprise such as continuity, execution, information, sustainability, commercial and regulatory.

Core to EY’s capabilities is advising our clients on how to identify the inherent risk, helping to implement mitigation strategies and build the required capabilities to monitor and manage the residual risk (see Figure 3).

Here are the steps an organization can take to better manage supplier risk.

1. Assess the third-party risk landscape, establish a governance structure that clearly delineates third-party responsibilities and request necessary data
   Complete cross-department assessments that establish shared likelihood scenarios and impact criteria for specific categories of third-party risk events. Identify what strategic, operational and financial uncertainty the company is willing to assume, and leverage this analysis to define the risk framework.
   Design a governance structure with clear reporting and escalation lines, providing sponsorship, coordination and strategic direction for the risk management activities. Effective governance brings focus and reduced complexity, streamlines decision-making and improves communication.

2. Segment suppliers and initial assignment of a risk score
   Perform third-party risk assessments and request data in line with the newly established risk assessment principles to obtain qualitative insights on how risk uncertainty is impacting your organization. Register these “approved vendors” and begin the process of segmenting these third parties by risk category. Utilize predictive analytics to compile a single weighted risk score, allowing for an organization to make better-informed decisions on the most effective investments to minimize uncertainty.

3. Integrate third-party risk management into business management processes through the development of due diligence and screening procedures
   Operationalize the third-party risk management framework by defining an integrated enterprise-wide approach, complemented by enabling technology, through a consolidated third-party data bank and focused resources.

4. Develop an onboarding strategy for new third-party vendors and create monitoring tools to determine status against performance and compliance measures
   Develop third-party due diligence (TPDD) and vendor onboarding (VOB) programs to onboard new, approved third parties. Consistently update third-party profiles, real time, through ongoing diligence techniques and scheduled risk assessments.
   The resulting operating model systems should be able to aggregate data, support analysis and report key risks such that there is a comprehensive view of risk that converts data into actionable insights. 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.

5. Deploy dashboard reporting around supplier developments to mitigate issue management and determine appropriate responses
   Issues are managed within organizations to determine recommendations to approve, conditionally approve, reject or escalate risks. Firm responses to risk events, identified during the risk assessments, are mitigated through industry-leading practices and risk management techniques.

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.

**Figure 3**

<table>
<thead>
<tr>
<th>Third-party management</th>
<th>Sourcing</th>
<th>Operational procurement</th>
<th>Third-party relationship management</th>
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<tbody>
<tr>
<td><strong>Third-party risk and</strong></td>
<td><strong>Request/ register</strong></td>
<td><strong>Segmentation</strong></td>
<td><strong>Onboarding</strong></td>
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<tr>
<td><strong>reliability</strong></td>
<td></td>
<td><strong>Screening/ scoring</strong></td>
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An integrated enterprise-wide approach, complemented by enabling technology, is necessary to create a seamless third party risk management process.
“Siloed” approaches to third-party risk management usually lead to contract governance gaps, overlapping monitoring programs and increased execution costs. Meanwhile, governments around the world are increasing the requirements for the tracking of pharmaceutical products throughout the third-party network and stepping up the enforcement of those regulations for all third parties. As pressures mount on costs and compliance, margins are squeezed and industry competition intensifies. Streamlining third-party risk management enables clients to focus on value-added mitigation and correction vs. data collection and processing.

So now is the time to take a proactive approach to managing the risk and optimizing investments in both managing uncertainty and monitoring relevant developments.

An effective third-party network will not only identify the necessary risks, but create a strategy and process for correction and ongoing diligence. There must be a focus on taking the observations that are accumulated and defining remediation strategies to get the correct response strategy from a company’s management team. EY’s remediation support can be used to help define that response strategy to the observed risk and escalate to the necessary party.

Understanding the full range of risks third parties pose is a starting point for broadening a company’s view (see Figure 4).

As companies and their third parties become more connected, there are more opportunities to control risks and provide proper oversight. Companies that embrace a movement toward coordinating their third-party network and focusing on cost control management will have a competitive edge in brand reputation, financial management, and operational effectiveness.

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**Figure 4**

<table>
<thead>
<tr>
<th>Third-party risk</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>1. Continuity &amp; Exit</td>
<td>Risk that a third party may fail to continue business as usual and the risk that the business would suffer a negative impact should the relationship with the third party need to be exited</td>
</tr>
<tr>
<td>2. Execution</td>
<td>Risk that a third party fails to meet execution standards and performance metrics agreed to in a contract</td>
</tr>
<tr>
<td>3. Privacy &amp; Security</td>
<td>Risk that an organization's data and/or system is lost or security is compromised</td>
</tr>
<tr>
<td>4. Financial</td>
<td>Risk associated with costs, including correct invoicing from suppliers and volatility of commodity inputs</td>
</tr>
<tr>
<td>5. Regulatory &amp; Compliance</td>
<td>Risk that a third party fails to comply with required local, federal or international laws and regulations as well as with internal policies, procedures and business standards</td>
</tr>
<tr>
<td>6. Geopolitical</td>
<td>Risk that the business will be impacted from operating in a specific country, including legal, regulatory and social-economic considerations</td>
</tr>
<tr>
<td>7. Strategic</td>
<td>Risk that a third party fails to support the organization's current and future plans and strategies</td>
</tr>
<tr>
<td>8. Sustainability</td>
<td>Risk associated with a third party not following ethical and sustainable practices</td>
</tr>
<tr>
<td>9. Reputational</td>
<td>Risk that the organization’s reputation will be adversely impacted should an event occur at your third party</td>
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</table>
Effective third-party management requires a comprehensive approach designed to illuminate and proactively address potential challenges across each of the stages, including qualification, integration, collaboration, development, performance management, risk management and phase-out of third parties.

To help our clients navigate these challenges, EY is introducing Outsight, a managed services offering designed to enhance benefits for our clients through objective and rigorous approaches to optimize and enhance third-party relationships.

Our methodology encapsulates the end-to-end view that is enabled through process and technology accelerators, including third-party process decomposition, diagnostics, health check, data visualization and analytics dashboards which, when combined with leading technology providers, enables a powerful mechanism to address challenges across the third-party management value chain (see Figure 5).

EY will provide a robust managed services framework to enhance both effectiveness and efficiency of third-party management, including enhanced visibility and control over highly tiered networks, improved governance programs, sector-specific third-party regulatory compliance, reduced contract value leakage, enhanced cybersecurity and technology-enabled insights designed to incisively pinpoint and remediate challenges associated with third-party management.

**Third-party management pain points**

- Difficulty in tracking the changing risk profile of the supply chain and its impact on the organizational risk profile
- No real-time feedback mechanism to link product receipt/service delivery to supplier performance
- Lack of governance and developed capabilities to manage a changing, more diverse supplier base
- No real-time tracking of any megatrends driving innovation and disruption in the industry
- Evaluation of supplier responses time-consuming and manual
- Evaluation process for all products and services are the same
- Supplier/Customer responses through email may not be updated accurately
- Increased inefficiencies in procurement decision-making
- Inaccurate spend and supply base analysis
- Lack of performance management design
- Limited insightful data analytics to identify saving opportunities
- Undefined roles and responsibilities
- Missing contract and risk management frameworks
- Lack of automated contract management processes, including manual renewals and terminations
- High contract management resource headcount due to low resource efficiencies
- Inconsistent supplier on boarding processes
- Supplier onboarding process is lengthy and requires multiple approvals or reminders
- Supplier/customer responses through email may not be updated accurately
- No real-time access to history of past POs or RFx
- Limited access to supplier/customer credentials for verification leading to incorrect details
- Undeined roles and responsibilities
- Missing contract and risk management frameworks
- Evaluation process for all products and services are the same
- Supplier/Customer responses through email may not be updated accurately
- Increased inefficiencies in procurement decision-making
Third-party transparency strengthens compliance

Challenge and EY role

An international consumer health products company had acquisition plans that would double the size of its third-party network. The company engaged EY to perform a current-state assessment of its third-party risk management program and to develop an integrated risk scoring and monitoring model that would support the company’s future-state operations. The engagement entailed benchmarking the client’s processes with supplier risk management leading practices, developing a comprehensive third-party risk management process overview and developing a high-level risk estimate for priority categories.

Benefits realized

- A single transparent approach 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 risks of both existing suppliers and those introduced through the acquisition.
- The program, once fully implemented, strengthens the company’s compliance with regulations around the third-party network.
- The company identified instances where the cost of managing third-party risk did not align with the potential overall risk to the organization. Aligning third-party risks and investment to monitor those risks will reduce the overall likelihood of the risk occurring and lead to potential cost savings.
Contacts

Niul Burton
Principal
EY Procurement Transformation Leader
Ernst & Young LLP
niul.burton@ey.com

David Fields
Principal
Head of EY Life Sciences Supply Chain Group
Ernst & Young LLP
david.fields@ey.com

Steve Arnold
Partner
Risk practice
Ernst & Young LLP
steve.arnold@ey.com

Eric Walsworth
Senior Manager
Total Supplier Risk and Reliability Offering Lead
Ernst & Young LLP
eric.walsworth@ey.com

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