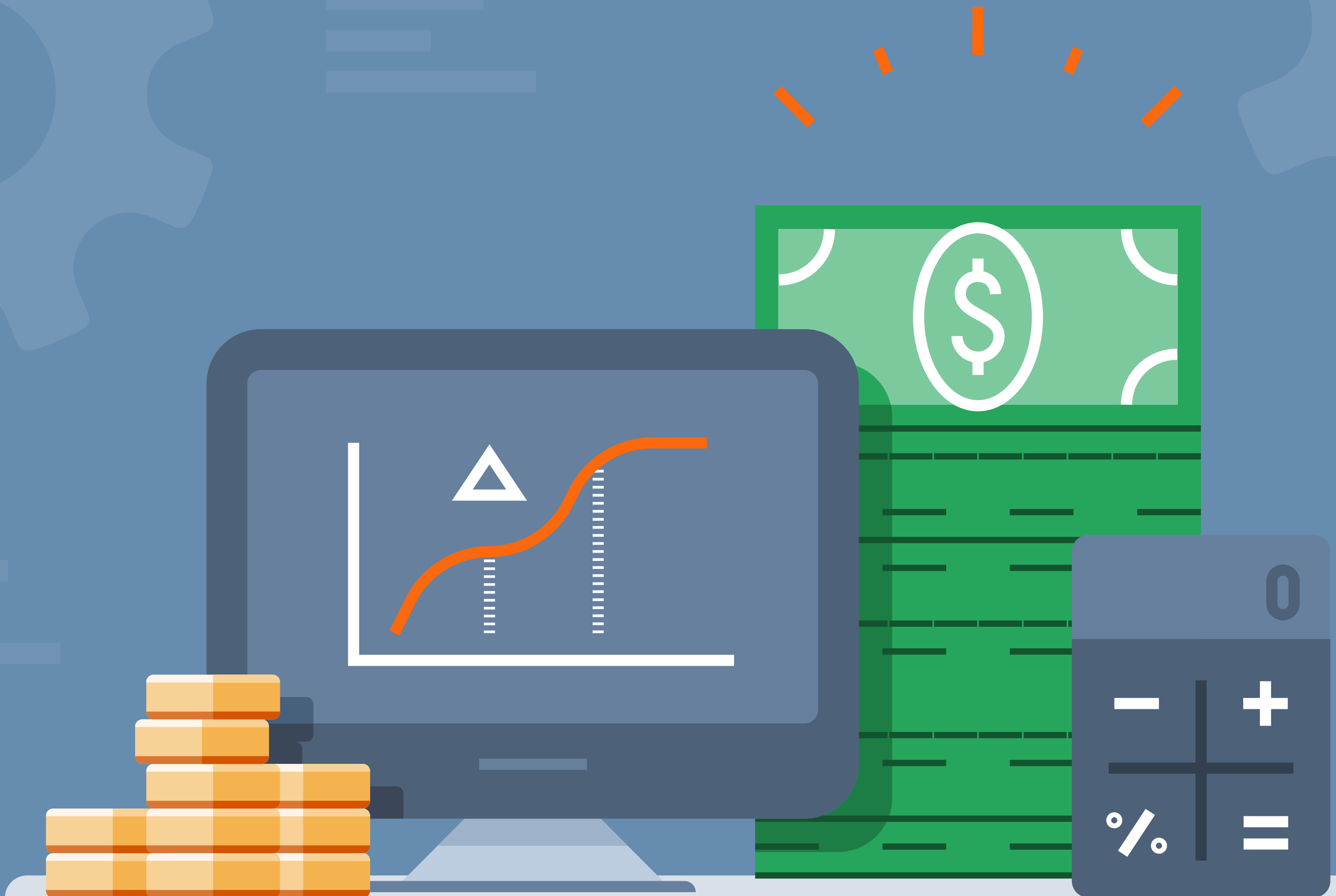
THE IMPORTANCE OF

Vendor and Supplier Financial Performance



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The Importance of **Assessment**

It's always surprising how few organizations are prepared to complete a true financial analysis on their outsourced vendor relationships. All federal level regulatory agencies now require an organization to understand the financial health of vendors and suppliers with whom it contracts for services and products. To be clear, collecting a financial statement from a vendor isn't enough. The process must include analyzing the vendor's financial health to determine the vendor's capacity to continue to provide safe, secure and quality products/services at the level you require.

This shouldn't be considered an extra item to do when there is spare time, but rather a regular part of the organization's due diligence and should be memorialized with an organized approach or internal policy to ensure consistent methodologies are applied when assessing the financial health of all vendors and suppliers.

Per the FFIEC Examination Handbook:

> *"Due diligence should serve as a verification and analysis tool, providing assurance that the service provider meets the institution's needs."*

The guidance is clear, but even more importantly, the health of your vendor, especially critical vendors, is a vital part of your overall risk management process and ultimately may affect your own reputation.

After all, a vendor's financial health affects how the organization operates and the amount of success it will achieve.

The OCC also provides guidelines on risk management of financial health across all third-party relationships:

Per OCC Bulletin 2013-29 regarding the assessment and management of risks associated with third-party relationships, the OCC adds a useful point around the importance of understanding a third-party's financial condition.

> *"Assess the third party's financial condition, including reviews of the third party's audited financial statements. Evaluate growth, earnings, pending litigation... and other factors that may affect the third party's overall financial stability."*

This provides useful guideposts for the importance of vendor and supplier financial performance that can be adopted by organizations of all sizes and across all verticals.

Regulators watch one another to see what guidance each other is putting out and keeps it in mind as they continue evolving their own requirements. It's a best practice to follow the most stringent guidance.

To further emphasize some key items to investigate when analyzing a vendor's and supplier's financial health, an organization should consider the following example documents:

- Annual financial reports (e.g., audited financial statements, 10-K filings for public companies)
- Revenue scale and trends (e.g., Is the company large or susceptible to competitive pressure? How has the revenue trended over time?)
- Profitability metrics (e.g., can be industry specific, consider net income, gross profit and operating income, determine if operations are sustainable and profitable over the long term)
- Solvency, liquidity and balance sheet ratios (e.g., cash flow performance, determine if the company can satisfy its current and future obligations)
- The potential financial impact of mergers and acquisitions or restructuring, as applicable
- Other considerations that could impact its financial performance (e.g., going concern opinion, litigation, supplier/customer concentration)

3 key items to investigate when analyzing a vendor's financial status should be:

- 10-Ks or annual reports
- Changes in revenue or assets/liabilities
- The impact of mergers and acquisitions

Performing an **Accurate Assessment** of the Vendor's Financial Performance

It's essential to obtain an accurate financial performance assessment of your vendors. Consider the following when performing an assessment:

1. **Do they have the revenue and/or have sufficient capital to support their ongoing operations?**
   This is the biggest driver of financial performance; if they're not making money, then they may not have the resources to improve their product or staff at appropriate levels for acceptable customer service levels.

2. **A company's net worth – are their liabilities exceeding their assets?**
   While this might not always be a red flag, it's important to understand the impact of a company's liabilities, especially if there is a trend of increasing liabilities from year-to-year. When liabilities are elevated, it's important that the vendor has a plan and sufficient resources to tackle them.

3. **Cash, and especially their current ratio, are other areas to look at.**
   This will help determine if they can sustain their operations at the current level and over the course of the next year.

4. **Inspect their debt-to-worth.**
   And, when applicable, research what outside rating agencies, such as Moody's, Standard and Poor's or Fitch, have rated their debt obligations. Also, take note if the ratings have either been upgraded or downgraded in the past 12 months.

Why Revenue Increases **Aren't What They Seem**

Revenue grew so the vendor's/supplier's financial performance improved, right? Wrong. Well, maybe. It depends on how much or how little that revenue grew, and the overall scale of the vendor/supplier within its broader landscape. Is the company a market leader or is it susceptible to competitive pressures from new entrants or other players in the industry? Did the company generate its growth all organically or through acquisition? These factors are important to dig into and understand more thoroughly when assessing the financial health of a vendor/supplier.

For many companies, one of the key components to financial performance and an indicator of financial health from a profitability standpoint is gross margin. Gross margin helps convey the level of profitability a vendor/supplier generates on its overall revenue basis versus its direct costs of goods and services. By assessing gross margin, one can see if the direct costs are increasing faster than its revenue and make an assessment on its overall financial health from a profitability standpoint from there.

A common problem with many vendors/suppliers is the limited data that is disclosed around a common metric like gross margin. In these cases, going a step further and reviewing other key profitability metrics, such as operating income, can help determine the financial health of the company from a profitability standpoint.

When combined with the assessment of a vendor's/supplier's revenue base and whether it has increased, the assessment of profitability (gross margin and/or operating income) can help provide a more comprehensive understanding on the financial performance for the vendor/supplier.

3 Useful Areas to Assess within a 10-K and 10-Q Public Filing

10-K public filings tend to be formatted in a nearly identical and consistent format for all publicly traded companies. These three areas in these publicly disclosed documents help provide incremental information on a vendor/supplier with respect to their financial performance:

First, look at risk factors. These are outlined in detail with special note to any regulatory action that might have occurred. The risk factors provide useful qualitative commentary on the potential risks that a specific vendor/supplier faces in the normal course of business operations.

Next, look for any legal proceedings or lawsuits that are pending, along with the estimate of the anticipated settlement charges. This data supplements the financial performance and information and can identify future risks and liabilities that may arise from current and pending litigation.

Finally, look at the auditor's opinion. Look at their opinion on financials, especially on comprehensive income, and their assessment of the adequacy of the internal controls in place. Given the auditor has done a detailed review and audit of the vendor/supplier and highlighted its findings on its internal controls, this level of detail can support additional areas of assessment when considering the overall financial performance of a vendor/supplier.

The Domino Effect of Declining Vendor Financial Performance

When companies have a negative trend with respect to profitability, many resort to a common tactic: they cut cost. One of the fastest ways to cut costs is by cutting staff, which typically leads to future issues from the vendor/supplier. These future issues include declining service levels, which aren't just defined by how long a vendor/supplier responds to a support ticket or problem with the product or service.

These specific cost reductions in different parts of the overall business, such as the operations team, will also likely mean a decrease in staff who are in charge of maintaining the security and integrity of the system. You'll also likely find a significant reduction in spending on product development, a legacy product being sunsetted or a sale pending on a poorly performing product or operating division. This could lead the vendor/supplier down a path of poor service levels, plagued with significant bugs, unresolved issues, long waiting periods and product or service downtimes.

When vendors/suppliers move down the path of cutting costs to improve profitability, it creates heightened levels of risk for your overall organization.

Unfortunately, in vendor/supplier contracts, lack of financial performance isn't a typically included condition for termination. Even if the financials of a specific vendor/supplier point to significant risk, your organization may not be able to contractually release itself from the contract because it isn't defined as a default.

As a result, the Service Level Agreements (SLAs) have become incredibly important as potential risk mitigants to manage for risk associated with vendor/supplier financial performance. It's imperative that your organization's product managers begin paying particular attention to the contractual SLAs during a period of poor or declining financial performance. The SLAs are an important part to manage vendors/suppliers, assessing the risk to your organization and developing “what if” scenarios to act and mitigate on the risk in the future. While poor financial performance from a vendor/supplier won't trigger a default for your organization, your SLAs to your clients can, and managing your vendors/suppliers to those can be a useful best practice to reduce your risk exposure.

Thoroughly Analyzing the Numbers Will Help You Discover Weak Financials

Weak financials may indicate underlying issues such as:

- Loss of business
- Litigation and bad press
- Lack of competitive advantage
- Decline in service levels
- Inability to retain internal expertise
- Loss of key management/executives
- Rapid staff turnovers
- Slow pay problems resulting in service level gaps or a decline in product quality
- Lack of infrastructure support and future development of innovative technology

Understand the Financial Health and Performance of Your Vendors and Suppliers

In today's ever-evolving and complex business environment, it's essential that your organization understands the financial health and performance of vendors and suppliers. By doing so, your organization can work to mitigate and address any potential risks from these vendors and suppliers, ensuring your business continues to effectively serve its current and future clients.

Remember the following helpful tips and best practices when adopting vendor/supplier financial health and performance assessments:

1. It is many times required by regulatory bodies.
2. The analysis must be done by qualified subject matter experts.
3. Decoding an annual financial report or audit on a vendor/supplier can be challenging. Ask for help if you need it.
4. Document your internal policies and standards to ensure consistency and rigor across your financial due diligence of vendors/suppliers.
5. Don't treat financial reviews as a check-the-box exercise.
6. Don't let the domino effect of declining financial performance from a vendor/supplier surprise you.
7. Plan for alternatives in vendor/supplier relationships to mitigate and minimize the downside impact to your organization's operations.
8. Regularly request financial information and documentation from vendors/suppliers to understand their recent financial performance and health.
9. Implement and incorporate monitoring of key vendors/suppliers.
10. Centralize documentation of financial health assessments and due diligence information on vendors/suppliers to keep a common, real-time repository to be used and managed by your entire organization.

Download a free sample financial health assessment and see how Venminder can help reduce your third-party risk management workload.

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About Venminder

Venminder is an industry recognized leader of third-party risk management solutions. Dedicated to third-party risk, the company is the go-to partner for software, high-quality assessments on vendor controls, certified subject-matter expertise and education.

Venminder's platform provides a centralized location to execute a third-party risk management program. It enables users to store documentation, onboard a vendor, track contracts, manage SLAs, send and manage questionnaires, manage due diligence and oversight, complete risk assessments, create workflows, run reporting and more.

Assessments performed by Venminder's qualified experts, including CISSPs, CPAs, financial risk analysts, paralegals and more, are readily available in an online library. The assessments enable clients to identify possible risks and understand areas of strength on their vendors' information security and privacy standards, SOC reports, financial viability, business continuity/disaster recovery preparedness, contractual standards, regulatory compliance and more.

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