

# The Importance of Assessing Supplier Financial Stability

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and the consequences if you don't



## 01 Overview

Suppliers are the lifeblood of many organizations. Regardless of what they are providing – a product, a service, or a combination of the two – companies depend on contractors and suppliers fulfilling their contracts.

While the symbiotic relationship between companies and their suppliers drives operations, that mutual reliance also introduces business risk. In a MIT-PwC survey of 209 companies with a global footprint, more than 60% noted that disruptions within their supply chains had led to a 3% or more drop in the respondents' financial performance.<sup>1</sup>

By gathering and monitoring key financial information on suppliers and contractors such as revenue, financial references, continuity plans, and third-party ratings, organizations can minimize the risks introduced to the business when partnering with a third-party firm.

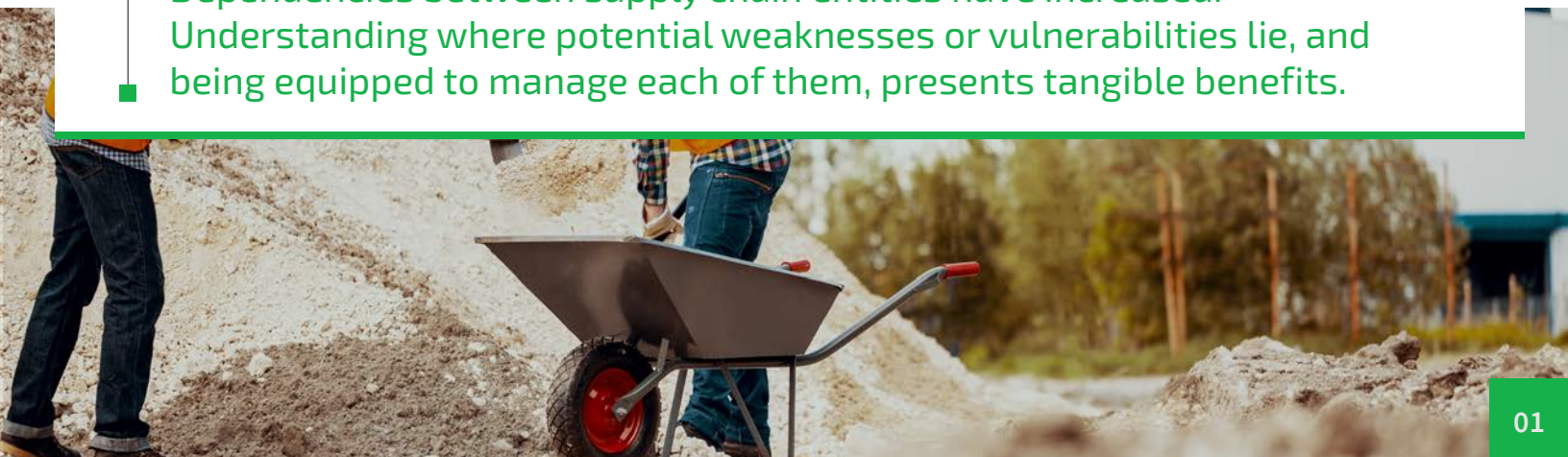
## 02 Why Assess Supplier Financial Stability

All business-supplier partnerships present risk. However, the level of that risk varies based on the services or goods being supplied. Some contractors and suppliers may be critical to your operations, while others play a smaller role and present less of a threat to business continuity. The increased correlation between supply chains and performance indicators uncovered in the MITPwC survey doesn't show signs of going away. Of the survey participants, 95% agreed or strongly agreed with the statement "dependencies between supply chain entities have increased."<sup>1</sup> Understanding where potential weaknesses or vulnerabilities lie, and being equipped to manage each of them, presents tangible benefits.

### By Minimizing Financial Risk, You Increase Business Confidence

Heavy up-front investment in any project comes with risk, restricting cash flow and a company's ability to pursue other potential sources of revenue. Generally, that risk is counteracted by a strong return on investment. But a project, and the project's funding, can be compromised if even one crucial supplier fails to deliver on a predetermined contract. Companies should be proactive and assess the financial stability of their partners in advance. This way, you can minimize financial risk and can increase business confidence with each new project.

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### By Identifying Where You Need to Diversify Suppliers, You Mitigate Skills

Relying on any one supplier for a business-critical product or service makes a company extremely vulnerable to forces outside its control. The MIT-PwC study found “supply chain operations were most sensitive to skill set and expertise (31%).”<sup>1</sup> It’s the corporate equivalent of putting every egg in one basket. If a supplier is no longer able to deliver on the contract, the business on the receiving end may be incapable of producing its own goods or services. Conversely, if the firm is able to source a specialized product or service from a number of places, it increases its flexibility and responsiveness to unforeseen events, be they financial upsets, global economic shifts, or natural disasters.

### By Strengthening Links in the Supply Chain, You Reduce Delays and Save Time

In a supply chain, one weak link can disrupt the flow of goods and services, which can ultimately create a “domino effect” for all suppliers and end users that follow in the chain. When a business is assured of its suppliers’ financial stability, it won’t have to dedicate time to managing or replacing one critical but unreliable supplier. As such, the business can effectively manage all of the suppliers and projects downstream.

### By Mitigating “Delivery” Risk, You Improve Customer Service

When a business can meet its project deliverables on deadline, it satisfies not only its investors and project stakeholders, but also its customers. Reducing down time and delays can lead to happier clients and a better reputation, which in turn results in new and/or repeat business. Lower delivery risk effectively translates to brand building and more secure revenue streams.

Ernst and Young research on supplier risk management found 90% of responding global financial service institutions are motivated to review supplier controls because it assists in shielding their brands and reputations, in addition to aiding compliance efforts and customer protection.<sup>4</sup> If a company is unable to fulfill promises made to end users and clients, its reputation is damaged, thus impacting its ability to secure new and repeat contracts and increase revenue.

## 03 The Consequences of Failing to Review Suppliers

Just as there are concrete benefits to assessing and monitoring supplier risk, there are tangible consequences for ineffectively managing risk, which also threatens business profitability and sustainability. “A successful supply chain depends on success of the entities present in the process and smooth flow of the products across the chain,” the authors of “Managing Supplier Insolvency” wrote in the June 2013 issue of the International Journal of Scientific & Engineering Research.<sup>5</sup> The financial standing or business failure of one supplier can have heavy repercussions on all the companies it works with or for. Deloitte identified some of the risks associated with supplier oversight – or lack thereof – in its 2012 report “The New Reality for Managing Supplier Risk.”<sup>2</sup>



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## Financial Loss

As KPMG study “Managing supplier failure risk” noted, a supplier’s financial risk can damage the value of the businesses it works with as well. When a major supplier suddenly goes under, its partners’ long-term business plans can come to a halt or be drastically altered. Plans for projects may be delayed until a new supplier can be found, estimates may require revision, and project opportunities can be lost; all of this can lead to substantial financial loss for an organization. Those aren’t the only ways additional costs can be incurred. KPMG cited the extra resourcing costs incurred when a supplier goes under, external analyst downgrades, “loss of customer goodwill,” and missed revenue opportunities as several ways value is lost.<sup>17</sup>

## Violated Contracts and Damaged Credit

If a supplier goes out of business and leaves its partners unable to meet deadlines or complete projects, these firms may violate contractual agreements with other enterprises. By failing to assess a suppliers’ financial stability and make the appropriate action, a company risks losing money and hurting its credit. Companies should not only understand the repercussions for failing to meet these obligations, they should take action to reduce the risk by assessing supplier financial stability prior to entering into a partnership.

## Reputational Impact

Positive reviews and referrals help firms secure additional contracts and win more projects. However, even healthy reputations can be put at risk when a business fails to proactively assess a supplier’s financial stability. When a supplier can’t deliver as expected, this reflects poorly on its partners, who may not be able to meet their own obligations and damage their customer trust as a result.

Financial instability isn’t the only supplier threat that can damage a business’s reputation. A third-party solution can help pre-qualify potential suppliers for other liabilities, such as safety or insurance risk, that could damage public perception of a company.



## 04 Ongoing Economic Uncertainty Breeds Risk

While economic conditions have improved since 2009, the repercussions of the struggling economy can still be felt, and supplier bankruptcies are still hindering the growth of some companies.

### Fisker Automotive and GM

Fisker Automotive, for instance, had to halt production of its highly anticipated Karma plug-in hybrid when its battery supplier went bankrupt. The firm, A123, went under in 2012, forcing Fisker to stop making its well-publicized vehicles and putting it at the mercy of public and investor scrutiny. The automaker ended up suing its supplier for a total of \$139.9 million for breach of warranty and failure to fulfill the contract.

However, Fisker was only awarded \$15 million of the amount it sought.<sup>6-8, 12-15</sup> Fisker's challenges with A123 stand in stark contrast to automaker General Motors' experience with the firm. GM relied on the supplier for batteries for its all-electric Chevrolet Spark, but once A123 went under, GM reassured the public that production of the vehicles was not expected to be negatively impacted. This suggests the automaker may have realized working with A123 posed a risk, and prepared appropriately, by establishing partnerships with other suppliers. For companies that rely on specialized or rare machinery and equipment – and the small number of suppliers who can service the equipment – having stable partnerships can help circumvent project delays, avoid disgruntled customers, and reduce the need for heavy infrastructure investment.

### Meta Rail

Metra, the commuter rail service in Chicago, uses equipment from the 1930s to help it direct switches for 7 of its 11 rail lines.<sup>9,10,11</sup> If any of the parts and maintenance suppliers Metra uses were to go out of business or become financially incapable of honoring their contracts, the transit authority could be left scrambling to find replacement suppliers and avoid delays for the thousands of commuters who rely on its services every day. Late trains and reduced service due to storms throughout the winter of 2013-2014 have already hurt Metra's reputation among riders.<sup>11</sup> If critical infrastructure was suddenly rendered useless due to a lack of replacement parts or maintenance skills, Metra could be forced to replace the entire rail-switching machine, which could cost up to \$172 million.<sup>9</sup>

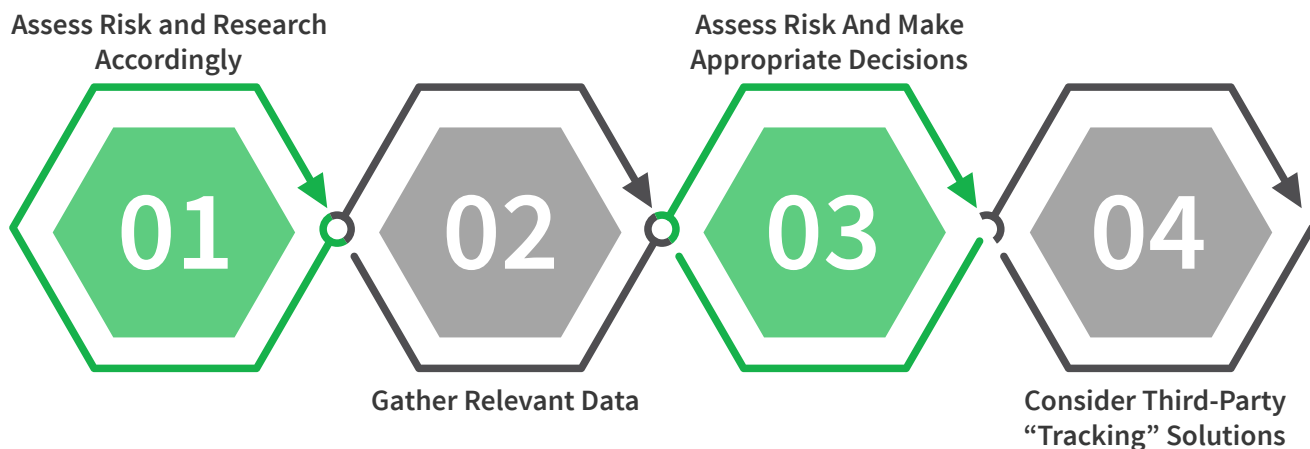


## 03 Exposing and Evaluating Financial Stability

Recognizing the importance of systematically assessing a supplier's financial health is the first step. Taking the next step to actually review and catalogue the risk levels of suppliers - and make necessary adjustments - will help a firm effectively insulate itself.<sup>16</sup>

“Clearly, recognizing and responding to a party's deteriorating financial situation before a bankruptcy filing is critical to maximizing your company's options and limiting harm to the project,” Jason D. McLarry, Senior Associate in the Construction Practice Group of Troutman Sanders LLP, wrote for the Construction Financial Management Association.<sup>3</sup>

“This entails a number of factors, including recognizing and avoiding risky subcontractors and owners, closely monitoring performance and payment practices following contract or subcontract award, and negotiating contract terms that allow you to assess the subcontractor and suppliers' financial positions and supplement their work in the event of bankruptcy.”



### Assess Risk and Research Accordingly

Supply chains present varying levels of risk. Based on an organization's culture and appetite for risk, not all suppliers may be required to participate in an assessment. For instance, an equipment maintenance firm that specializes in niche industry machinery is likely more integral to the company's operational continuity and harder to source than the contractor providing copier maintenance. Each class of supplier will have its own level of required information.

### Gather Relevant Data

Once you have determined which suppliers to assess, you need to gather relevant data to determine a supplier's financial health. Firms may find it most beneficial to gather and assess the following information:

- Annual Revenue
- Third-party financial ratings
- Business continuity plans
- Financial references
- D&B scores
- Debarment searches
- Legal searches (judgments/liens/bankruptcy)
- Mergers and acquisitions

## Consider Third-Party “Tracking” Solutions

Ensuring financial stability by conducting financial risk assessments of all critical suppliers and keeping this information updated and accurate may strain a firm’s resources. Organizations that are unable to dedicate time to review and monitor the financial stability of suppliers should consider partnering with a third-party solution, like Avetta, that will gather, validate, and track supplier financial information, along with other prequalification and compliance data.

Avetta assists companies with aggregating the financial data needed to screen suppliers, including annual revenue, third-party financial ratings, business continuity plans, and much more to enable you to assess the reliability of your supply chain. Avetta also offers financial risk assessments for suppliers, which are calculated with leading experts to predict the likelihood that a business could go bankrupt or default on its obligations.

## Conclusion

Developing long-term, stable business partnerships depends on selecting financially viable suppliers. Entering blindly into a supplier relationship by failing to monitor existing suppliers’ financial health exposes a company to project delays, damaged reputations, lost revenues, and wasted time. By gathering key supplier financial information such as revenue, financial references, continuity plans, and third-party ratings – and, just as importantly, continuously updating the supplier risk profiles – organizations can ensure they minimize the threats introduced to the business when partnering with a third-party firm. and in the software that your vendor uses to support your needs.



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## About Avetta

Avetta connects leading global organizations with more than 85,000 qualified suppliers, contractors, and vendors across 100+ countries. We support the sustainable growth of supply chains through our trusted contractor prequalification, supplier audits, insurance monitoring, robust analytics and more. With real results in helping companies reduce TRIR, our highly configurable solutions elevate safety and sustainability in workplaces around the world—helping workers get home to their families each night.