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# Supplier Assessment and Monitoring – Systems and Tools to Improve Visibility to Global Supply Chain Risks

W h i t e p a p e r



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# Supplier Assessment and Monitoring – Systems and Tools to Improve Visibility to Global Supply Chain Risks

## Introduction

In the wake of rapid globalization and a consistent increase in sourcing from international markets, supplier risks are becoming more difficult to monitor. Both product manufacturers and service providers with global supply chains, face considerable challenges monitoring suppliers in traditional and emerging markets. The major challenge that organisations face today is the lack of awareness of the risks associated with their complex supply chain, and the need to stay on top of these. Language and cultural differences and the unavailability of detailed financial information (particularly relating to private suppliers) is coupled with lack of required internal monitoring mechanisms and physical distance from supplier locations, creating significant challenges. In addition, suppliers often have a complex network of subsidiaries and subcontractors that can complicate the monitoring process. Even those multinationals with strong sourcing teams in their suppliers' country may only be focussed on procurement activities, and often lack systematic supplier monitoring procedures to keep track of existing suppliers' financial and operational health. Only by identifying and managing risks effectively can manufacturers and service providers turn global sourcing into a sustainable competitive advantage.

Most of the existing supplier monitoring approaches, such as internal monitoring based on traditional rating mechanisms and working with rating agencies, are no longer adequate in global sourcing environments. Procurement teams based in a single location do not have global reach; local procurement units rarely have expertise, and rating agencies fail to cover some of the most prominent sourcing destinations such as China and India. Other limitations such as homogeneous rating practices applied to suppliers offering different products or services and in different industries, historical rather than forward looking ratings, and lack of or infrequent onsite supplier visits and management discussions can alter the true position of a supplier significantly. Rating agencies tend to focus on public and large private companies, and do not cover small or medium private players. In such scenarios, third-party vendors who specialise in supplier performance evaluation and monitoring can collaborate with procurement organisations as business partners to achieve this goal and fill such gaps in an organisation's risk management process.

## Best practices

Although organisations are now increasingly becoming aware of the importance of constant supplier assessment and monitoring, there is an inherent void within the practices (if any) developed to address these concerns. According to a benchmarking study conducted by SAP America Inc, constant supplier evaluations are a "must have" for the adoption of best practices within procurement. The study further stated that procurement organisations are slow to adopt best practices in key areas such as supplier performance management. At the same time, cost cutting has put supplier risk assessment on the backburner in many organizations.

Some of the main causes of supply chain issues in today's business environment are leaner supply stocks, international and multi-tiered supplier networks, and offshore manufacturing facilities. Such strategies have led to increased risks such as product or service delays and disruptions due to longer and more complex supply chains. An organisation's supplier risk management system should have

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set practices in place which identify and rate risk categories and mitigation techniques.

Initial due diligence of new suppliers is one end of the risk management spectrum, but staying on top of suppliers' performance during the product or service cycle should be the main focus today. Risk mitigation should involve close monitoring and visibility of suppliers and their supply chains and effective contingency plans to adapt to potential problems. This is imperative as the financial impact of a supply chain disruption can erode the bottom line and damage brand equity as well as customer loyalty. No global sourcing company should face a situation where it is unaware that one or more of its key suppliers are in trouble and are unlikely to deliver. General Motors spent millions of dollars on developing its Chevrolet Camaro, which was scheduled to go into production in February 2009. The bankruptcy of an interior parts supplier delayed the car production by a full month. Such events can have a direct impact on the company's profitability and a ripple effect on dealers and even other suppliers of the company. The bankruptcy of Nortel Networks as a result of the economic slowdown prompted many of its customers to scout for new suppliers that could provide a more solid financial outlook. Of course, pre-established contingency plans can help mitigate these kinds of problems. Although some of Nortel's clients remain, they have now put back-up suppliers in place. The new key objective is to develop a system that systematically identifies alternative suppliers ahead of time – not after an organization's main supplier has run into financial trouble.

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In most cases, the process of supplier assessment in its traditional form involves classifying the suppliers into different categories and using the same classification until the next round of financial results are declared without factoring any significant developments in the interim. Currently, organisations also tend to lay more emphasis on historical performance without assigning enough importance to suppliers' strategic and operations goals and other qualitative parameters. Although historical performance can help highlight apparent negative trends, it may fail to identify the root cause of the problem. Under the current economic scenario, strong historical performance may not be enough to ensure a secure future performance. Qualitative parameters need to be given higher significance than quantitative parameters. Nortel Networks is losing its customers due to lack of innovation, lack of understanding of client requirements and inadequate marketing strategies – a strong supplier monitoring system would have picked these deficiencies up long ago.

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Mitigation strategies such as ERP systems and customised (not standardised) risk-rating mechanisms are important tactical and strategic approaches to risk management. Organisations should make it a norm to regularly assess and monitor their supplier base, including tier two and three suppliers on a set frequency and employ a rating system to identify critical risk parameters. The reassessment frequency depends on the overall risk assigned to a supplier. Strong relationships should be built with key suppliers and regular discussions should be held with them. A key supplier is generally determined based on the anticipated spend and criticality of the product or service procured. Procurement organisations have begun to recognise the scope of services offered by third-party vendors and are partnering with such companies to optimise their procurement activities.

Best practices of supplier monitoring entail in-depth initial and ongoing assessment on the following indicative parameters:

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## **Business Strategy**

Semi-annual or annual assessment of key parameters such as sustainability of the supplier's economic model, investment in R&D, intellectual property ownership, market position, production and service capacities available versus current and projected demand, key customers, capacities and revenues committed to them, exposure to other industries, diversification of product and service base, the impact of M&A and loss of partners will help organisations gauge the strength of the business model and equip them to meet required expectations. Further, a detailed understanding of the supplier's industry is essential for a thorough top-down analysis. An example of potential customer diversification risk is the current situation Toyota, Honda and Ford Motors are experiencing with their auto component suppliers who have been dependent on Detroit car manufacturers for business. These suppliers are currently facing the risk of bankruptcy due to the trimmed operations of Chrysler and General Motors. Eventually, these suppliers will pose a threat to Toyota, Honda and Ford since they may not be able to maintain their product operations. According to industry estimates, approximately 59% of Chrysler's suppliers also supply Honda and other Asian-based manufacturers and 54% also supply Ford.

## **Operational viability**

Efficient operational controls such as quality and product certifications, business continuity plans or supply chain issues can help determine any inherent problems in product quality and delivery continuity. Annual assessments of process, quality and product certifications, more frequent monitoring of supply chain issues and staffing trends, labour unrest, etc., should be considered.

## **Financial assessment**

Detailed financial assessment, especially for non-blue chip suppliers, should be carried out on a quarterly basis, where factors such as suppliers' profitability, cash positions, insolvency indicators, debt positions, financial management strategies and asset losses, can be assessed. This would help determine any significant change in the financial position of the supplier. Business prospects in terms of projected order books, capacity expansion plans, diversification and growth plans will have a direct impact on the financial strength and should therefore be discussed frequently with supplier management.

## **Supplier brand image**

Brand reputation can be gauged through multiple stakeholders in the market such as suppliers' customers and competitors. It is an important tool for competitive benchmarking against best in class suppliers. Further, suppliers spend on marketing & sales activities, product innovations and an assessment of their competitive advantages are important indicators of their ability to maintain brand image in the market.

## **Supplier contract management**

Any inherent risks associated with signing contracts, such as adhering to service-level agreements, payment terms, discounts, penalties and clauses, should be identified. Ongoing contract risk assessment helps streamline the process, reduces certain risks and adds value to the contracts. Organisations should be able to identify certain important clauses that may result in inadvertent penalties or losses. It will also help ascertain certain hidden clauses in pricing terms or hidden discounts, thereby not only increasing the value of the contract but also increasing the organisation's net profit.

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But where does all the information come from that is necessary for monitoring these parameters? On the one hand, suppliers are simply asked to submit regular and updated information about their operational and financial performance, business strategies and outlook. On the other hand, in-depth and frequent discussions with supplier management and onsite visits to gauge further potential risks and business prospects are essential.

The reality of the situation remains that few procurement organizations have the necessary resources – in terms of numbers but also in terms of expertise – to cover all aspects of supplier monitoring internally. That's why third party providers specialized in different aspects of the monitoring process have mushroomed lately. Often, regular supplier monitoring is conducted by an internal team that is proactively involved with their suppliers' performance assessment and supported by third-party vendors proficient with offering specialized services based either in the supplier's country or in proximity to the supplier. As a case in point, the famous US retail chain Wal-Mart, after a series of scandals resulting from the poor quality of its products, outsourced a majority of its quality control operations to a specialist firm of auditors based in its suppliers' country of operations to leverage the auditors' local knowledge to assess and maintain quality standards of their suppliers.

Similarly, far-sighted practices to develop early warning signs of suppliers' financial health (and understanding suppliers' market updates) are often outsourced to research and analytics service providers that can generate the manpower to collect the information and also have the expertise to interpret the findings. The simple approach is to crunch data provided in quarterly or annual reports. But in order to stay ahead, and particularly because privately held suppliers do not provide any standard reporting, procurement departments are now moving to customized monitoring based on predefined reporting cycles agreed with their suppliers.

### Conclusion

*Having a well-defined framework for supplier assessment and monitoring will help organisations take necessary steps to mitigate risks and set up mechanisms to identify future risks.*

Having a well-defined framework for supplier assessment and monitoring will help organisations take necessary steps to mitigate risks and set up mechanisms to identify future risks. A robust supplier monitoring process involves all aspects of a supplier's business – operational and strategic, financial data as well as quality metrics. As in-house resources are scarce in most procurement departments, third-party monitoring partners are increasingly employed to apply tested frameworks for supplier assessments that provide “decision ready” information to organisations to create risk portfolios and to make necessary changes to their procurement strategy. At the end of the day it's about core capabilities: In a globalized sourcing market, organizations must have forward-looking monitoring systems in place. But it is hardly a key function of procurement teams to collect and analyze the relevant information – the core capability must be around interpreting the information provided by the monitoring systems or partners and identify the consequences to their supplier landscape.

Despite all the efforts toward risk mitigation, limitations (in-house or third party supplier monitoring) will exist and are unavoidable. There is no guarantee of the accuracy of the information collected from suppliers and some “secrets” may remain undetected even after diligent investigation. However, companies that can effectively manage supplier risks are less vulnerable in global markets.

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