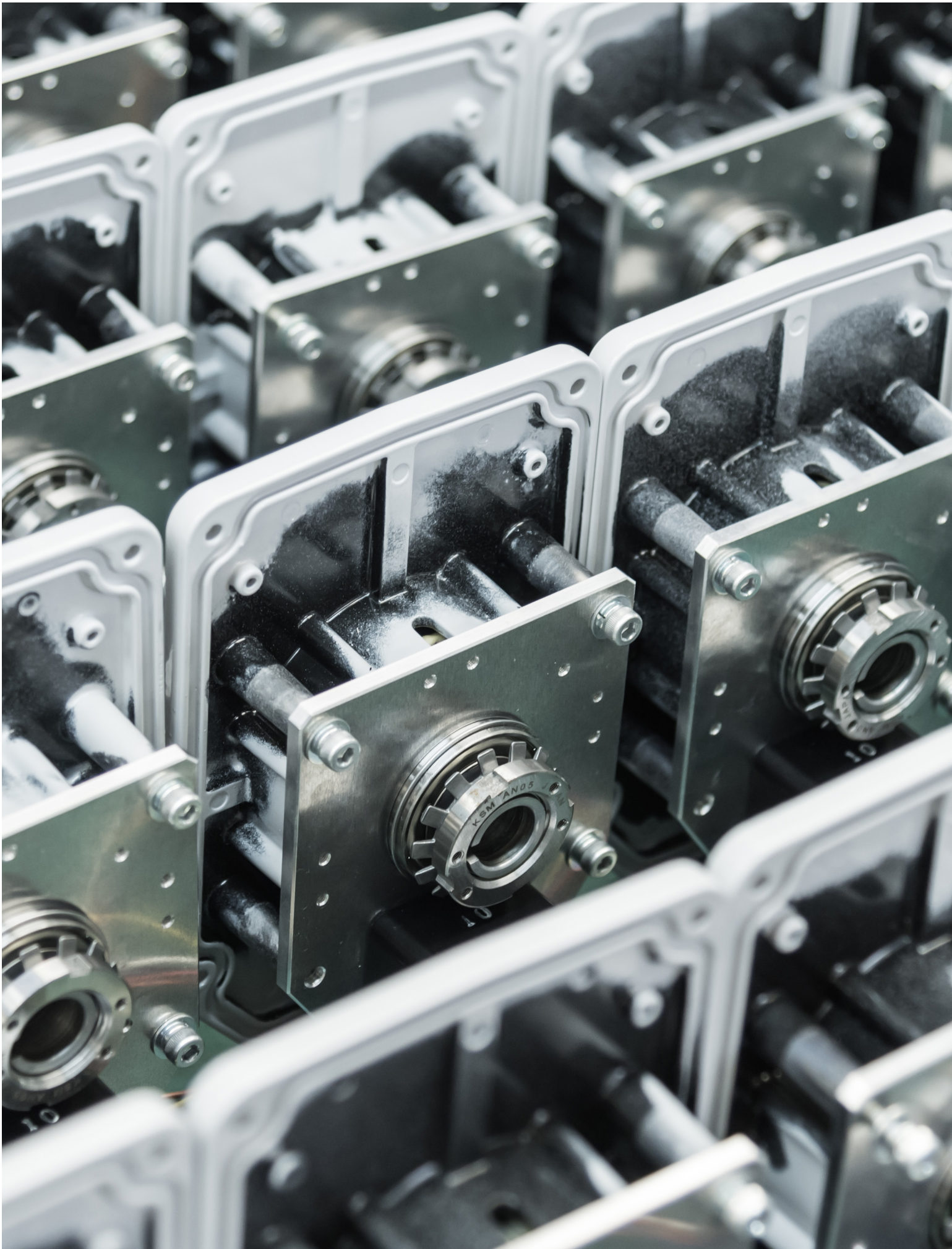# Deloitte.

**Effective third party
risk management**
Exploring strategies to improve
contract management

Risk ●

The third party paradox

Organizations in every industry have come to rely on third parties for their day-to-day operational needs. Although third party relationships were once predominantly driven by the need to reduce costs, organizations now depend on third parties to enhance organizational agility and scalability, and to introduce product or service innovation by leveraging specialized knowledge or skills.

In light of this shift, reliance on third parties continues to grow. In a recent Deloitte global survey on third party risk, 73.9 percent of respondents said they believe third parties will play a highly important or critical role in the year ahead, up from 60.3 percent a year ago.[1] This speaks to the importance of fostering and maintaining strong third party relationships.

Despite the benefits these relationships promise, however, reliance on third parties also exposes organizations to higher levels of risk. In the survey cited, a full 87 percent of respondents admitted they had faced a disruptive incident with third parties in the last two to three years, with 28 percent reporting they had suffered a major disruption and 11 percent experiencing a complete third party failure. Notably, third party risk areas run the gamut from the threat of high-profile customer service disruption to the risk of regulatory breach, from reputational damage and supply chain breakdown to exposure to financial fraud. Perhaps most critical is the risk of contract-related cost leakage during third party engagements. This issue significantly impacts return on investment, particularly on major projects, and is a problem that almost all companies experience.

1. Deloitte. "Third party governance and risk management: The threats are real." (2016). Accessed at http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-third-party-gov-risk-management-2016-printable.pdf on May 30, 2016.

The risks are real

In Canada, third party risk is a current, costly and critical challenge. In the past three years alone, numerous Canadian organizations have suffered serious repercussions due to third party management process failures. Projects that have gone sideways can spark contract-related disputes with suppliers that may escalate into litigation, costing organizations time, money, and potentially reputation.

A lack of oversight has also seen several government contractors sued for project mismanagement, fraud, and corruption. The situation has become so significant that the previous federal government introduced anti-corruption rules to ban companies charged with specific offences from contracting with Ottawa for a five-year period.

Digging deeper

To address these concerns, organizations are taking steps to enhance the maturity of their third party governance and risk management. Yet, despite the strides they have made, significant gaps still remain—particularly with regards to the tools, technologies, and underlying processes currently in place. According to the survey, 94.3 percent of respondents have only low to moderate levels of confidence in the tools and technology used to manage third party risk.

The lack of effective tools, technology, and processes also frequently results in cash leakage. This issue is of unquestionable importance to public sector organizations and those in energy and natural resources that regularly undertake major capital projects, but *all* organizations are affected to some degree by an inability to effectively reduce overpaying third parties. There is a significant need for a better way to reduce third party risk while maximizing operational efficiencies and contract management. Using new tools, technologies, and processes, such as those expressly designed to

improve cost-recovery efforts, will be critical to reaching this goal and driving competitiveness.

Audits identify the problems

The gaps in the third party contract management process emerged through our experience preforming vendor billing reviews. We found process and overpayment issues consistently arise during organizations' audit of their actual spend of third parties versus contract terms. After conducting several contract management reviews, going back four years each time, we discovered opportunities to recover 3-5 percent of their contracted spend. With some capital-spend projects in the billions, the loss can be substantial.

On average, the recovery opportunity on third party contracts is 3-5 percent of an organization's contracted spend.

A number of causes were discovered during these audits. For example, the personnel responsible for entering into contracts often operated separately from those who approved and used the services. This prevented teams from tracking contract set-up, execution, and administration across the enterprise. Common symptoms that we have encountered are entire process systems are manual in some organizations, making it difficult to access the information needed to properly verify an invoice. Without adequate technology to support and structure that process, and without access to personnel who could help validate the accuracy of contracts on a real-time basis, losses were not only persistent but difficult to quantify.
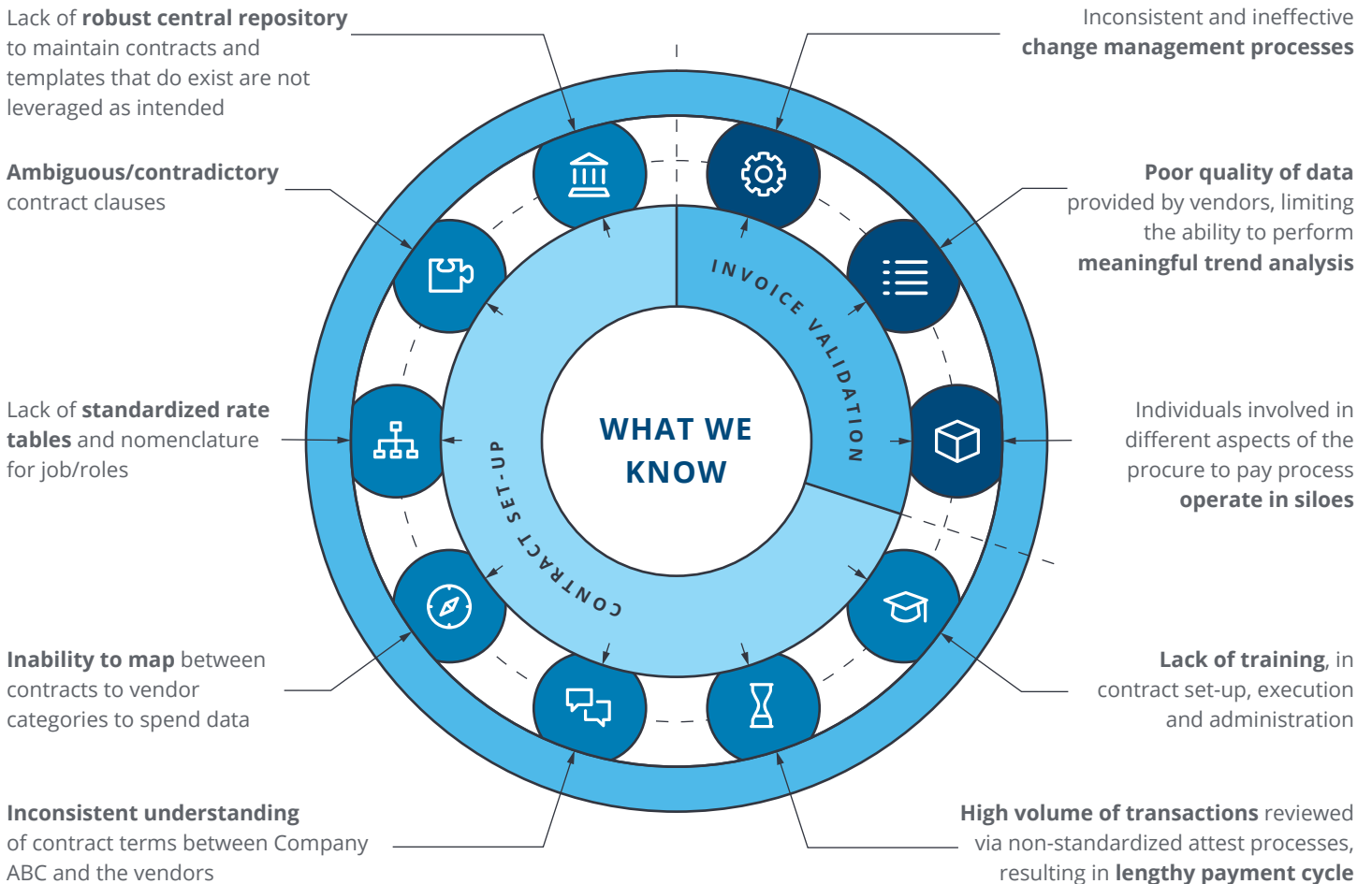
Most organizations heavily invested in Enterprise Resource Planning (ERP) platforms believe they have strong controls. This may be generally true, but there is substantial ambiguity around contract terms, making it difficult to understand when an invoice is inaccurate. ERP controls may catch the major issues, but missing just a few small ones can add up.

A lack of integration among the tools and technologies presents problems of its own. These include an inability to map contracts to vendor categories or spend data, poor data quality that interferes with the performance of meaningful trend analysis, and reliance on non-standardized processes, which result in lengthy payment cycles. The reality is that most organizations cannot effectively review their invoices given their resource capacity and technology constraints.

Third party contract management process efforts face a number of challenges

A number of common pain points have been identified that lead to cash leakage of 3-5 percent related to vendor overbillings.

Lack of **robust central repository** to maintain contracts and templates that do exist are not leveraged as intended

Ambiguous/contradictory contract clauses

Lack of **standardized rate tables** and nomenclature for job/roles

Inability to map between contracts to vendor categories to spend data

Inconsistent understanding of contract terms between Company ABC and the vendors

Inconsistent and ineffective **change management processes**

Poor quality of data provided by vendors, limiting the ability to perform **meaningful trend analysis**

Individuals involved in different aspects of the procure to pay process **operate in siloes**

Lack of training, in contract set-up, execution and administration

High volume of transactions reviewed via non-standardized attest processes, resulting in **lengthy payment cycle**

WHAT WE KNOW

INVOICE VALIDATION

CONTRACT SET-UP

After-payment recovery is not always successful

Determining what costs should be recovered is only half the battle. Once identified, the challenge becomes collection. Only 25 to 75 percent of third party costs identified as recoverable are actually collected. Much of this is due to internal process deficiencies, this time in the post-payment phase. Like the effort required to validate and attest invoices, current post-payment processes are largely manual, which makes them challenging to execute and extremely difficult to improve without adopting the right technology and deploying the right people to manage the process.

Those challenges can be exacerbated in decentralized companies where ownership of third party risk falls into question. Determining ownership and accountability once the procurement and legal departments have executed the contract, as well as confirming who is responsible for identifying risks and developing the risk profile, can be difficult.

New approaches present new solutions

Leading organizations are leveraging analytics and technology to reduce payment cycles. The largest trend that we've seen best in class leaders headed toward, is a more dedicated model to manage contracts. This approach requires assigning dedicated personnel, either internal or with the help of an external expert, to support monitoring and managing contract terms, invoice validation, and overall third party cost management. Through our experience, we have found that organizations that assign dedicated personnel to manage third party contracts proactively on an ongoing basis, have seen significant improvements managing this risk.

A real-time approach sets clear expectations between organizations and their third party partners and facilitates reduced payment cycles, containing costs before overpayment occurs. This not only drives cost savings for organizations, but can also improve their third party relationships. Ensuring greater clarity for all parties from the outset eliminates time lost debating contract terms and reduces the possibility of needless claims and contentious legal issues down the road.

A real-time approach can also help organizations automate their contract set-up and attest activities while expanding contract management coverage across a greater proportion of their third party base. This allows them to gain visibility into the full breadth of their transactions, regardless of how many third parties they work with.

In addition, organizations that implement this approach effectively will generate a positive return on investment allowing savings to be reinvested in the organization.

By assessing contracts on a real-time basis, rather than during the post-project phase, organizations can gain assurance that they are only paying the agreed-upon contractual amounts.

Real-world results

Organizations that have relied on the right people to establish appropriate processes and implement a more real time approach, have realized measurable results:

- One organization that combined a real-time approach with advanced data analytics and visualization techniques was able to identify significant recoveries by accessing unrealized volume rebates, resulting in potential cost savings of $1.1 million.

- In another instance, third party assurance professionals were able to use standardized labour data captured while a project was in progress to perform a real-time productivity analysis. By identifying several contract non-compliance, project efficiency, and health and safety issues, the organization realized potential cost savings of $745,000.

- In a third case, a business in energy and natural resources was facing third party relationship challenges due to its reliance on a manual billing process, inaccurate invoicing practices, and inconsistent approaches to dealing with different third party providers. By resolving potential anomalies on a real-time basis prior to invoice submission, this company was able to prevent cash leakage, accelerate invoice payments to take advantage of early payment discounts, and prevent claims by resolving issues proactively. This not only supported the business but also strengthened the relationship with their third party.

Optimize the value of third party investments

As organizations continue to rely on a rising number of third parties to grow and thrive, it is becoming increasingly difficult to effectively manage third party costs. This strengthens the business case for a more real-time approach, and the reliance on processes and specialists that can help organizations considerably reduce invoicing errors.

Contacts

To learn more about Third Party Risk Advisory, please contact us.
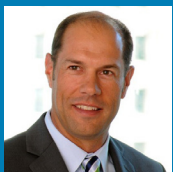
Tim Scott
Partner
Third Party Risk Advisory
tiscott@deloitte.ca

Poonam Singh
Partner
Third Party Risk Advisory
posingh@deloitte.ca

Munir Patel
Partner
Third Party Risk Advisory
munirpatel@deloitte.ca

Laura Clare
Senior Manager
Third Party Risk Advisory
lclare@deloitte.ca

Anne-Héloïse Bédard
Senior Manager
Third Party Risk Advisory
abedard@deloitte.ca

Deloitte.

deloitte.ca