Who are you doing business with?

How to balance the risks and rewards of third-party intermediaries

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In the evolving global marketplace, leveraging third-party business partners (a concept Deloitte Advisory calls the "extended enterprise") can help companies find innovative ways to bring products to market, enter new geographies, access specialized talent not available in-house, reduce time-to-market, and lower service delivery costs. To do all those things more effectively, many companies are working with third-party intermediaries (TPIs) for logistics, sales, distribution, marketing/research, licensing/permitting, human resources, and more.

The benefits and challenges of working with TPIs

Relationships with TPIs may be crucial to boosting sales, increasing efficiencies, and furthering a company's vision and growth strategies. But these relationships also come with risks, such as:

- Compliance (potential violations of US and international law)
- Financial (potential revenue leakage and increased costs)
- Business continuity (service interruption)
- Reputational (reduced brand perception)
- Operational (decreased control over processes and service levels)
- Cyber (poor data security and over-reliance on third-party safeguards)
- Strategic (misalignment of an organization's strategic objectives)

Making the extended enterprise web even more complex, there are often "fourth parties"—entities engaged by TPIs—that can present risks to a company.

By way of recent example, this year's Panama Papers disclosure has highlighted the potential corruption, fraud, money laundering, and sanction-related risks with conducting business with certain third parties, particularly in higher risk foreign jurisdictions. In addition, the disclosure has increased the importance of having visibility into the ultimate corporate ownership structure of customers, vendors, and other third-party business partners.

As another example, additional regulatory and compliance-related risks associated with TPI relationships may arise under US and international laws such as the US Foreign Corrupt Practices Act (FCPA), which primarily serves two purposes: First, to prohibit bribery of foreign government officials (and in some cases, non-government officials). Second, to require companies to maintain accurate books and records and a robust anti-corruption compliance program with comprehensive controls (such as regular monitoring/auditing of TPI relationships and ongoing risk assessments).[1] Other global anti-bribery and corruption statutes may have additional provisions, such as prohibiting commercial bribery of non-government individuals.

The benefits and challenges of working with TPIs (cont.)

Recent enforcement trends have shown that global regulators aren't shying away from large fines, penalties, and sanctions (such as deferred prosecution agreements and corporate integrity agreements). In 2014, for example, 100 percent of all FCPA enforcement actions brought by the Securities and Exchange Commission and Department of Justice involved some form of TPI relationship. In the same year, corporate penalties and fines from FCPA enforcement actions totaled over $1.5 billion, with the average corporate penalty amounting to $157 million—the highest average in history.[2]

Companies are also becoming more aware of the value a robust compliance program can provide in identifying, managing, and mitigating potential risks throughout the extended enterprise. According to a Deloitte Consulting LLP survey, only 22 percent of respondents indicated that their company's extended enterprise risk management and compliance function was "above average." seventy-two percent of respondents stated that their organizations didn't have adequate tools and processes in place to manage TPIs.[3]

Recognizing extended enterprise risks

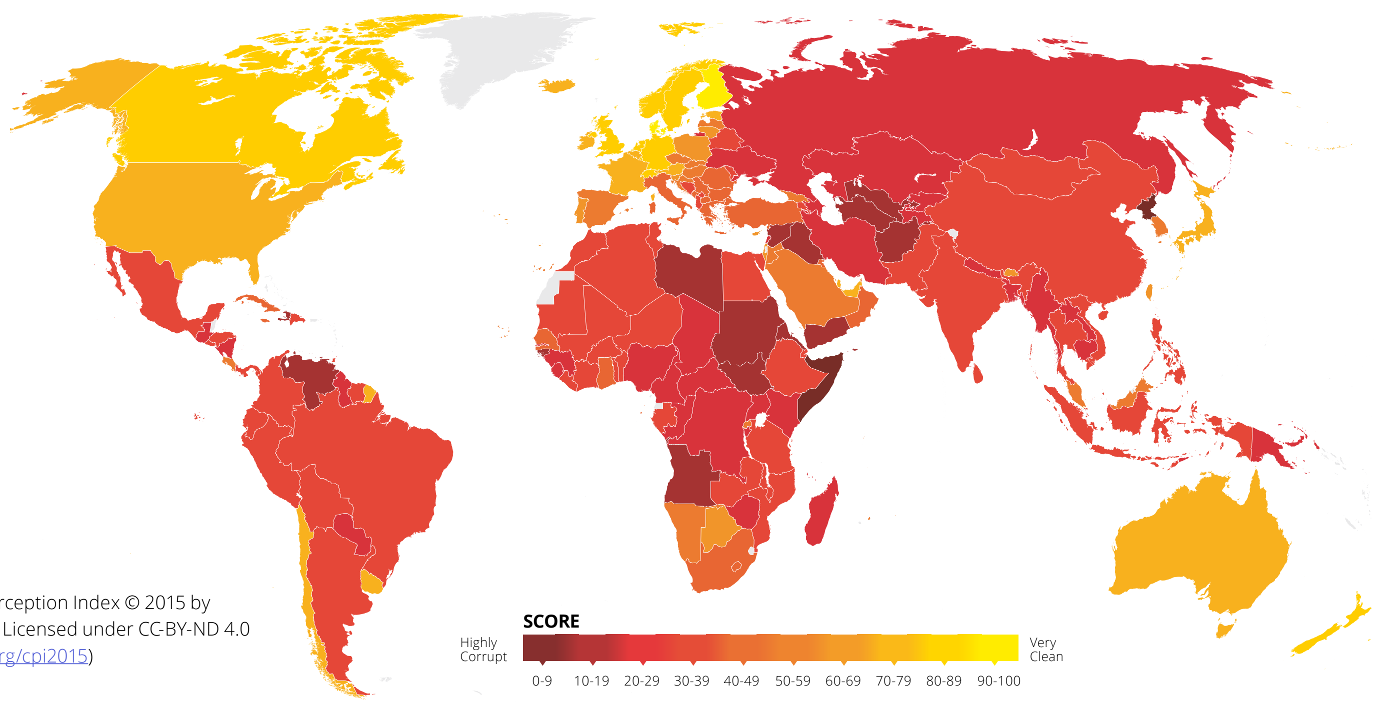
To establish and maintain effective (and compliant) relationships with TPIs across the globe—and particularly in emerging markets—a company should consider understanding the underlying risks. Factors that should be considered and addressed in potential TPI engagements throughout the extended enterprise include:

- **Local regulatory standards.** Arrangements by and among companies, TPIs, and various customers and end users may be subject to extensive regulation under country-specific standards relating to fraud, corruption, abuse, quality, and other issues. Therefore, companies may wish to evaluate country-specific regulations, assess global compliance requirements, and train and supervise foreign subsidiary management to follow laws and policies.
- **Contract deficiencies and lack of visibility.** Contracting standards for TPI arrangements in the local country may differ from those employed in more developed markets. In addition, contracting arrangements with TPIs, if they exist, often lack the terms and conditions necessary to safeguard the interests of the company and measure the performance of the TPI. To potentially mitigate these factors, companies may wish to negotiate contracts to provide guidance and definitions of price points, discounts, allowances, rebates, commissions, free products/services, and so forth with distributors, manufacturers, and other TPIs. Companies may also consider negotiating fees paid to vendors, such as travel agents, conference organizers, and sales agents, at arm's length and at fair market value (with deviations from established pricing guidelines being evaluated and approved by senior-level members of management). And finally, companies may consider including (and exercising) rights to audit, as well as anti-corruption provisions, in TPI agreements.

- **Local business practices and culture.** In many emerging markets, certain financial arrangements and other business practices with TPIs may be incompatible with a US-based organization's ethics and values. For example, illegal pricing schemes and information leaks to competitors may actually be regarded as customary business practices in some emerging markets. Another problem may be denial. When locally based employees and managers face a conflict of interest—such as pitting personal performance goals and rewards against reporting poor results and bad news to corporate—culture (compounded by self-interest) may motivate people to mislead or become deceptive.

To determine whether a given market may present inherent corruption-related risks (and pose compliance risks to a company's extended enterprise), consider Transparency International's Corruption Perception Index, which scores the level of perceived public sector corruption in each country.

Figure 1: Transparency International's Corruption Perception Index



Source: 2015 Corruption Perception Index © 2015 by Transparency International. Licensed under CC-BY-ND 4.0 (http://www.transparency.org/cpi2015)

- **Response to change.** Even as organizations respond to increasingly stringent regulatory requirements, individuals working with or through TPIs may be tempted to circumvent those requirements. Improved global data analytic techniques, trending assessments, and focused auditing and monitoring can help organizations identify suspicious patterns that may require further investigation. Such activities may not eliminate this growing risk. But they could alert companies to problems before they have a significant financial and regulatory impact.

Know your "red flags"

As part of ongoing monitoring and auditing procedures around TPI relationships, companies should keep an eye out for potential red flags, such as:

- TPIs that interact with government institutions and/or officials on a company's behalf
- Vendor payments inconsistent with contracts terms
- Requests for reimbursement of fees and/or expenses with limited documentation or evidence of services performed
- Contract terms that are vague/ambiguous, or neglect to include an audit clause
- Overseas contract manufacturers that have rights to sell products in other countries (potentially leading to the distribution of "gray goods")
- Off-the-record discussions
- Introduction of additional third parties by TPIs into transactions
- Upfront payments and deposits requested by the vendor to secure business
- Unusually high commissions, large credit lines, free products/services, and discounts granted to distributors
- Use of local travel agents that aren't approved corporate global vendors
- Incomplete or inaccurate information in required disclosures
- TPIs that refuse to certify compliance with FCPA or other local laws, or refuse to agree to reasonable financial and other controls during course of business
- TPIs that lack facilities and staff to perform required services
- Payments made through convoluted means (e.g., numbered accounts in the Bahamas)
- TPIs that are incorporated or established in an offshore jurisdiction
- Channel distribution agreements where a product passes through several checkpoints

Know—and exercise—your options

Companies doing business in and with emerging markets should consider aligning their approach to TPI arrangements with their risk objectives, including those relating to risk management, integrity, ethical, and compliance values. Examples of how companies may potentially mitigate or transfer risks include:

- **Apply local and global standards consistently to TPI arrangements.** Understand the application of local laws, business practices, culture, and regulatory standards. Consider integrating local standards with global regulatory requirements. Develop the company's global approach to compliance in coordination with legal counsel and others who have business and regulatory experience within the specific country.

- **Perform due diligence.** Consider verifying the qualifications, reputation, ethical conduct, financial, and other resources of TPIs. Such due diligence may be risk-based, with TPIs of higher potential risk (e.g., located in new/emerging markets, interacting directly with foreign officials or state-owned enterprises, recent subjects of whistleblower complaints or other compliance inquiries) requiring a heightened level of research. For these entities, diligence may entail adverse media research, social media searches, and in-country source inquiries.

- **Consider implementing clear, specific right-to-audit clauses.** Exercise right-to-audit clauses to review the activities of certain high-priority and/or high-risk TPIs. But be alert to TPIs that attempt to limit the effectiveness of such clauses. For example, TPIs may claim that their accounting systems don't allow them to easily bifurcate data related to expenses that may be shared with a company's competitors, potentially raising confidentiality concerns. Under such scenarios, a company might not be able to review certain transactions and activities (such as marketing) that the distributor may be performing on the company's behalf.

- **Structure applicable and specific contract language.** Explicitly state the obligations and responsibilities of the TPI, establishing the contractual terms in coordination with legal counsel and others with expertise in local laws and practices. Terms may include the specific nature of services to be provided, the scope of permissible relationships between the TPI with those in a position to influence the volume or value of products and services, and the scope of permissible financial arrangements with the TPI.

- **Conduct in-depth market assessments.** Include market research and benchmark studies in assessments and compare agent or intermediary fees paid across industries and geographies.

- **Maintain a contract management system.** Keep copies of vendor and service agreements when expiration dates and renewal terms are not automatically updated, and make sure those documents are easily accessible. Develop a process for maintaining all TPI relationships and risks, performing a complete inventory to ensure that all contracts are current and in-line with company procedures.

- **Conduct ongoing risk monitoring.** Active, risk-based monitoring of TPIs and auditing plans that assess significant compliance risks are an essential element of an effective compliance program. Consider proactively sensing and responding to risks and opportunities facing third parties by vetting and screening compliance assessments.

- **Document business need and purpose.** Specify the legitimate business purpose or need for creating relationships with TPIs, and inquire whether a competitive pricing process was followed before a decision was made to engage a TPI.

- **Establish fair market value.** Establish and document compensation payable to TPIs at rates and fees that are consistent with fair market value for services that are necessary to meet the legitimate business needs of the company. This includes royalties and other fees paid by or through the TPI, as well as commissions, free products/services, rebates, or discounts to distributors. Local management and policy may mandate that a fair market value assessment is conducted and followed before agreeing to written terms and conditions. Companies may require that deviations from pricing guidelines be approved by senior management.

- **Customize practical policies, processes, and internal controls.** Policies developed at a company-wide level may not fully succeed in certain countries due to insufficient understanding, competing priorities, or lack of buy-in. Therefore, policies, processes, and internal controls may need to be flexible to accommodate local requirements and the established company culture, business model, and code of conduct. Policy implementation may also be accompanied by a change in management strategies.

- **Implement an effective training and anti-corruption program.** Modify training initiatives so they suit the needs of the local market, are delivered in the local language, and are backed by the support of local management. Provide training on an ongoing basis to sales professionals, managers, finance and accounting professionals, and TPIs. Align employee goals and incentives with expectations from corporate headquarters and local management.

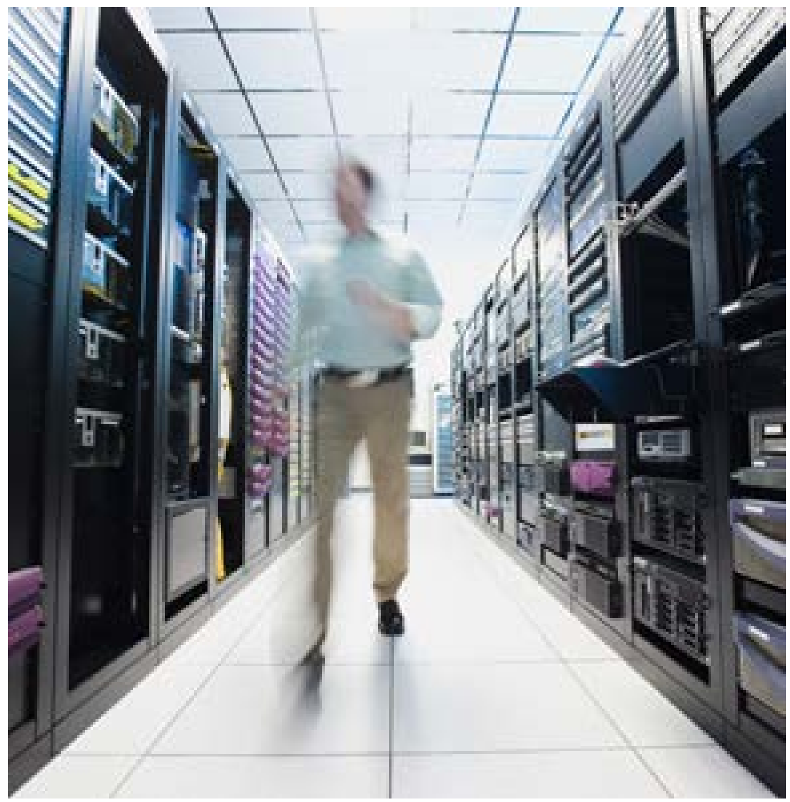
- **Introduce applicable payment and performance processes.** Include the internal controls necessary to establish and document the propriety of the payment to and performance by the TPI, as well as compensation for local management based on achieving specific sales and market share goals. Processes may include documentation regarding proof of performance, performance measurement, review of the third party's compliance practices, and maintenance of adequate books and records.

- **Be prepared for contingencies.** Maintain response protocols to address potential compliance issues that may be identified during the course of a TPI arrangement. To deal with allegations of non-compliance, corruption, or other misappropriation of assets or lack of good faith by TPIs (or employees interacting with TPIs), have a response protocol that promptly investigates matters and takes remedial steps to mitigate future risk. When a TPI risk is identified, establish remediation procedures that define how to properly manage the risk going forward. And have clear ownership of who within the organization is responsible for risk management.

How Deloitte Advisory can help

While the focus of this perspective is primarily on corruption and fraud-related risks that may exist across the extended enterprise, it's clear that companies face many other TPI risks, including supply chain disruption, reputational loss, data risk, product recalls, poor performance, and negative financial impact. Still, the potential benefits of the extended enterprise (e.g., product and service innovation, expansion to new markets, increased access to talent, and access to advanced technologies) that allow companies to focus on their core business processes cannot be ignored. That's why it's critical that organizations implement a program to effectively manage these vital TPI relationships to drive performance, enhance value, and mitigate risk.

Deloitte Advisory's extended enterprise risk management (EERM) framework presents a detailed approach for managing TPI relationships. Our capabilities and suite of solutions are designed to increase the performance of the extended enterprise. This enables us to help organizations achieve their strategic business objectives while appreciating the associated risks.



Our EERM framework is supported by three pillars: Strategy and program development; evaluation and continuous monitoring; and technology enablement. This framework may be integrated across the organization, as well as to specific risk domains and TPI relationships. It can also help management address key TPI relationship challenges and questions, including:

- How do we identify, assess, and potentially mitigate the corruption and fraud-related risks associated with our TPI relationships?
- How does our overall compliance program (particularly with respect to TPIs) compare to current regulatory requirements and industry leading practice? Are our TPIs keeping up?
- How do we bridge the gap between those in the business and our compliance and risk staff?
- How do we ensure that appropriate contracts are in place with TPIs, that they are meeting expectations, and they are complying with contractual commitments?
- How can we use data and analytics to make informed decisions about our TPI relationships? What tools and technologies should we leverage?
- What data should we be monitoring and analyzing to make real-time decisions?
- How will evolving technologies, market trends, or disruptive forces present opportunities and challenges to our TPI relationships?

Figure 2: Deloitte Advisory's EERM framework

Strategy and program development
Solutions to assess, design, and implement strategically aligned extended enterprise program

- Compliance program benchmarking and gap analyses
- Controls testing
- Third-party compliance training
- Regulatory compliance
- Governance and operating model design
- Strategic risk assessment, tiering, and segmentation
- Crisis management and simulation modeling

Evaluation and continuous monitoring
Solutions to assess third parties and proactively sense and respond to extended enterprise risks and opportunities

- Anti-corruption health checks
- Background checks and integrity due diligence
- Internal corporate investigations
- Third party FCPA assessments and investigations
- Litigation and dispute support
- Third-party vetting and screening
- Risk sensing
- Contract compliance assessments and optimization
- Benchmarking
- Analytics and visualization
- In-depth market assessments
- Supply chain forensics and A/P analysis
- Sanctions screening and program assessments

Technology enablement
Solutions to transform and continuously enhance extended enterprise risk management by designing, implementing, and deploying technology solutions

- Analytics platform and compliance dashboard
- Vendor portfolio and transaction risk scoring
- Data visualization
- Advanced and predictive analytics
- Economic and statistical analytics
- Risk and compliance
- Intelligence
- Governance/program management
- Knowledge management

Who are you doing business with?

How to balance the risks and rewards of third-party intermediaries

More and more organizations are becoming increasingly dependent on the extended enterprise, and regulatory bodies are focusing more heavily on enforcement activity. As a result, implementing processes, procedures, and controls to identify and mitigate regulatory and business risks associated with TPIs is taking on greater significance.

Given the breadth, depth, and complexity of managing TPIs, it's critical that organizations implement an end-to-end approach to improve the maturity of their extended enterprise programs, which may include expertise and resources to assist in strategy and program development, evaluation and continuous monitoring, and technology enablement.

Knowing how to recognize and respond to the risk warning signs when working with TPIs may help organizations realize both practical and competitive advantage—from better managing their extended enterprise and increasing shareholder value to reducing the scrutiny of regulators and avoiding reputational damage.

Endnotes

i US Department of Justice and Securities and Exchange Commission, "A Resource Guide to the U.S. Foreign Corrupt Practices Act," November 2012.

ii FCPA Digest: Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act, Shearman & Sterling LLP, January 2015.

iii Global Outsourcing and Insourcing Survey, Deloitte Consulting LLP, May 2014.

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