RISK MANAGEMENT FOR THIRD-PARTY RELATIONSHIPS

Webcast Series - Part II
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INTRODUCTION
Presenters

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Agenda

• Recap of first webcast
  ▪ Define third-party relationships
  ▪ Review the third-party relationship management lifecycle

• Review current issues and share perspectives on risks impacting third-party relationship management today:
  • Performance improvement
  • Contract compliance
A third-party relationship is any business arrangement between an organization and another entity, by contract or otherwise.

### Examples of Third-Party Relationships

<table>
<thead>
<tr>
<th>Vendors</th>
<th>Suppliers</th>
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</thead>
<tbody>
<tr>
<td>Distributors</td>
<td>Licensees</td>
</tr>
<tr>
<td>Customers</td>
<td>Professional Service Providers</td>
</tr>
<tr>
<td>Subcontractors</td>
<td>Service Contractors</td>
</tr>
<tr>
<td>Contract Manufacturers</td>
<td>Business Partners</td>
</tr>
<tr>
<td>Brokers</td>
<td>Resellers</td>
</tr>
<tr>
<td>Agents</td>
<td>Non-Contractual Parties (e.g. UPS)</td>
</tr>
</tbody>
</table>
Third-Party Relationship Management (TPRM) Lifecycle

Planning
- Need
- Specifications
- Define population of third-parties
- Develop list of qualified third-parties
- Develop RFP
- Manage bid process

Termination
- Contract termination and expiration
- Contractual termination requirements
- Final audit and settlement
- Legal closure
- Post-mortem review and lessons learned

Contracting
- Contract administration
- Initial deliveries
- Continued delivery
- Payments
- Quality controls
- Performance metrics and feedback
- Compliance audits
- Insurance verification
- IT security and privacy

Ongoing monitoring
- Third-party negotiations
- Critical elements of agreement
- Contract development and final signature

Due diligence and third-party selection
- Bid evaluation
- Evaluate qualifications
- Third-party selection

Tax Implications

Process improvement

Mergers & Acquisition

Security & Privacy

Anti-Bribery

Technology Solutions

Third-party Relationship Management
THIRD-PARTY CONSIDERATIONS RELATED TO PERFORMANCE IMPROVEMENT
Third-Party Relationship Management

• Third-party relationship management is pivotal to your success
• Third-parties provide specialization and expertise
• Effective relationships begin long before pricing discussions and contracts are signed
• A good relationship requires
  ▪ Understanding your needs/goals
  ▪ Finding a good match
  ▪ Negotiating a fair agreement
  ▪ Ongoing communication concerning service expectations and performance
Understanding Third-Party Requirements

- Do **not** let third-parties define your requirements
- Establish ownership for the product or service to be provided and the supporting third-party relationships
- Involve all stakeholders
- Assign a weight to each requirement
- Identify absolute requirements vs. nice-to-have
- Present requirements to potential third-parties and include in third-party selection and management process
Understanding Third-Party Risk

• Assess the risks of the product or service the third-party will support

Transaction/Operational  Liquidity/Financial  Credit  Reputation
Strategic  Compliance/Legal  Strategic  Rate/Pricing

• Identify specific risks and include how they are mitigated in your third-party evaluations
Evaluating Third-Party Risk

• It’s important to understand risk not only for third-parties, but for each of the goods and services delivered.
• To protect the organization, examine the factors third-parties could impact, if the arrangement were to go badly:
  ▪ What will the impact be on the third-parties’ business strategy?
  ▪ What could the impact be on the organization’s reputation?
  ▪ What could the impact be on the organization’s operational risk?
Third-Party Selection

• The organization should have a systems development and acquisition policy
  ▪ Analysis
  ▪ Due diligence
  ▪ Formal request for proposal (RFP) for major systems
  ▪ Preferred third-party listing is also an option

• A well-defined acquisition policy provides a basis for sound selection decisions
Third-Party Selection Criteria

• How well does the third-party address our requirements?
• How does the third-party solution mitigate our risk?
• How secure is the third-party?
  ▪ Financial
  ▪ Information Security and Controls
• What is the third-party record with customer service?
  ▪ References and User Groups
  ▪ Problem Management and Enhancement Process
  ▪ Service Monitoring Capabilities
• Are the contract terms fair?
  ▪ Price, term, service levels, etc.
Third-Party Due Diligence Checklist

- Existence and corporate history
- Qualifications, backgrounds, and reputations of company principals, including criminal background checks where appropriate
- Other companies using similar services from the provider that may be contacted for reference
- Financial status, including reviews of audited financial statements
- Strategy and reputation
- Service delivery capability, status and effectiveness
Understanding Third-Party Contracts

- Duration
- Dispute resolution
- Indemnification
- Limitations of liability
- Termination
- Assignment
- Foreign providers
- Regulatory compliance
- Scope

- Performance standards (service-level agreements [SLAs])
- Security and confidentiality
- Controls
- Audit
- Reports
- Business resumption
- Subcontracting
- Ownership and licensing

Contracting
Common Gotchas in Third-Party Contracts

- Contain one-sided clauses
- Inadequately address service levels (with penalties)
- Silent about regulatory requirement maintenance
- Multi-year auto renewal term
- Excessive notification lead time for opt out
- Does not address deconversion
- May require payment for disputed items
- May ask for payments before delivery
Third-Party Contract Management

- Maintain a central repository for all agreements
- Assign responsibility for management and oversight
- Manage key dates and ongoing due diligence
  - Periodic performance reviews
  - Insurance Coverage
  - Business Continuity Testing
  - Financials
  - Changes in Leadership
  - Data Breaches
  - Legal filings
  - Notices to the third-party to prevent auto renewal
THIRD-PARTY CONSIDERATIONS RELATED TO CONTRACT COMPLIANCE
Why Companies Conduct Third-Party Compliance Audits

Reactive

- Monetary obligations are nonexistent, late, or trending downward
- Services or products are not delivered on time
- Quality issues
- Public information and press releases are contradictory to the performance of the agreement

Proactive

- Company has developed a third-party contract compliance risk management process
- Fiduciary responsibility to organization stakeholders
- Agreement is financially material to the organization
- Company is looking to restructure the agreement
- Agreement will be expiring soon
- Induce future compliance
Third-Party Relationships – Compliance Red Flags

*Third-parties and your agreements that exhibit at least one of the following characteristics have an increased risk of non-compliance with the terms and conditions of the contract:*

- Complexity of agreement
- Multiple locations or parties involved (related and non-related parties)
- Changes in accounting and reporting systems
- Changes in third-party key personnel
- New products, services or expanded product lines
- Mergers and acquisitions
- Third-party reporting/financial obligations are late or cease to exist
- Performance provided by third-party do not correlate with market/industry trends
How and why a company’s third-party management program often falls short in preventing or detecting contract compliance:

Deficient language for appropriate contract oversight
- Reporting templates do not exist within the agreement to ensure the third-party has a framework to be in compliance with the terms and conditions
- Contracts don’t include appropriate language to minimize the risk of nonperformance and aren’t clear as to repercussions of nonperformance
- Contracts are not reviewed with accounting and operations prior to execution
  - Lack of alignment with how the business processes and accounts for activities
  - Increases revenue leakage and/or costs
  - Potential for interpretation ambiguity with the third-party

Inadequate right to audit clause
- Audit clause is not sufficiently structured
- No emphasis for third-party accountability
- Ability to assess the control environment of the third-party
- Duration third-party needs to maintain books and records is not sufficient
- Clear and enforceable end of agreement rights
How and why a company’s third-party management program often falls short in preventing or detecting contract compliance:

- Contracts are not centrally located and tracked
- Employees may not have the underlying contract and/or all corresponding amendments
- Intimate knowledge of third-party existence and activities are limited to comparatively few employees
- Nuances between similar agreements with other third-parties are not understood
- Clear ownership for monitoring activities does not exist and the monitoring activities are ad-hoc and manual
- Lack of formal process to assess changes in the third-parties organization
- Notifications of non-compliance are not identified as the issues arise
Eventually, contract termination is an inevitable phase in the third-party relationship lifecycle. Reasons for contract termination may include:

- Confidential information - what happens to data (data retention or destruction)
- Reputational risk
- Business continuity - disruption of operations
- Monetary considerations

Considerations to manage situations when termination occurs:
- Clearly specified contract termination rights in the contract
- Internal transition plan (timeline and responsibilities)
Key Message – Contract Compliance Assessment

Example Scorecard

- Responses to survey questions from each selected third-party are assessed and ranked using a scoring model customized for the organization.
- The example scorecard shows mapping customized by agreement type.

Take Away

- Develop and enforce process to identify, understand, and monitor all third-party relationships
- Address risk throughout the third-party relationship lifecycle
- Document organizational risk profile, risk tolerance, and risk acceptance
- Exercise due diligence to minimize risks (including regulatory fines and reputation damage)
- Treat Third-Party Risk Management holistically
- Be innovative and flexible: program and processes should allow for incorporation of changes due to business, industry, and regulatory drivers.

### Contract Compliance Scores

<table>
<thead>
<tr>
<th>Risk Factors</th>
<th>Score</th>
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<tbody>
<tr>
<td>Agreement complexity</td>
<td>2.2</td>
</tr>
<tr>
<td>Significance of agreement to the organization</td>
<td>3.3</td>
</tr>
<tr>
<td>Number of third-parties involved</td>
<td>1.0</td>
</tr>
<tr>
<td>Changes in key third-party personnel</td>
<td>1.5</td>
</tr>
<tr>
<td>Changes in third-party accounting systems</td>
<td>4.7</td>
</tr>
<tr>
<td>Performance compared to industry/market conditions</td>
<td>3.0</td>
</tr>
<tr>
<td>Changes in agreement terms</td>
<td>3.2</td>
</tr>
<tr>
<td>Timeliness of compliance by third-party</td>
<td>2.7</td>
</tr>
<tr>
<td>Lack of compliance by third-party</td>
<td>2.0</td>
</tr>
<tr>
<td>Mergers and acquisitions related to the third-party</td>
<td>1.0</td>
</tr>
<tr>
<td>New products or activities related to the third-party agreement</td>
<td>3.0</td>
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Contract Compliance Audit Process

Key considerations:
• Reviews can span multiple years if agreement is properly structured
• Can be performed where books and records are located or as desktop reviews
• Findings can help fund compliance program for future reviews
• Cost of the audit frequently shifts to the third-party
Contract Compliance Monitoring and Post-Audit Resolution Process

1. Contract Monitoring
2. Identify Compliance Defaults
3. Notification and Monitoring
4. Negotiations
5. Dispute Resolution
6. Cure
7. Terminate
THANK YOU FOR YOUR TIME AND ATTENTION
Wrap-Up

• Thank you for participating in the Risk Management for Third-Party Relationships webcast series

• Replay and slides will be sent to all webcast registrants and participants next week

• For further information on this topic, please contact
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  ▪ Christina Churchill - christina.churchill@rsmus.com