Managing supplier failure risk

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Supplier failure can destroy value in your business

The failure of a critical supplier or of a supplier’s critical supplier can have a severe impact on businesses due to delays to capital projects, stopped production or empty shelves. In many cases the cost of dealing with these situations can run into millions and absorb significant management time.

Value can be destroyed in a range of ways

- Immediate lost revenue and liquidated damage claims
- Interruption of production
- Additional costs to resource
- Delays to major capital investment projects
- Requirement for increased management time
- Loss of customer goodwill
- Reputational damage and potential loss of any competitive advantage
- Adverse stakeholder reactions including analyst downgrades

Examples of value destruction

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<th>The failure of a baker threatened bread supply at a major supermarket chain. The supermarket had to make an emergency purchase of the baker to ensure continued supply.</th>
<th>The Japanese earthquake and tsunami have impacted many production lines. This came as a surprise to many companies who did not appreciate the global nature of their supply chain.</th>
<th>Late delivery of garments at a fashion retailer resulted in the season being ‘missed’ and heavy discounting to sell the items. The reduced profitability resulted in a covenant breach.</th>
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<td>Financial difficulties at a major Tier 1 automotive supplier resulted in several OEMs having to make large financial payments to the supplier each month to ensure production lines were not closed down.</td>
<td>The financial distress in a supplier to a major oil and gas capital project created major delays to an oil exploration programme. The oil and gas company had to invest significant time and money to resolve the problem to bring the capital project back on schedule.</td>
<td>The cessation of gas supplies from Russia due to a dispute with Ukraine meant many component manufacturers in Central and Eastern Europe had to close down production facilities thereby threatening production at European OEMs.</td>
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Dealing with supplier failure after the problem has arisen can be a very expensive process.
Moving from crisis management to proactive avoidance

As the cost of resolving a supplier failure problem can be very high, it is essential to develop an advanced warning system and to take early intervention steps. Achieving this will minimise disruption and reduce value destruction. Nowadays, it is not sufficient to rely on historical financial information or credit ratings.

Identify:
Most companies do not spot issues as early as they could given the information available to them. Basic historical financial information and credit rating scores do not provide sufficient information for identifying problems.

Mitigate:
Many companies have a process to identify the problems but then do little to actively mitigate the risk that this can pose.

Control:
Except in those organisations that are ‘best in class’ for supplier failure risk management, there are few or no allowances in supply agreements to facilitate the provision of relevant information or collaborative working practices.

Example of early intervention
A global automotive OEM identified the early warning signs of the performance of a major parts supplier. Recognising the risk, the OEM was able to start to dual source the products and build up an inventory buffer. When the supplier eventually failed, the OEM had a smooth transition to new suppliers with no disruption to its production lines.

Reducing risk from supplier failure means companies should:
- Have effective systems in place to identify and regularly monitor supplier failure risk.
- Consider the impact of global crises or disasters on the supply chain.
- Quantify the cost of supplier failure / disruption to the business.
- Have preprepared, robust contingency plans in place for those suppliers deemed to be ‘at risk’.
- Have supply agreements setting out the rights to obtain information and check supplier status.
- Regularly convene supplier risk discussions bringing procurement, finance and operations together to review and monitor ‘at risk’ suppliers.

Do your current systems and processes proactively monitor and assess the risk of supplier failure to your business?
Identifying supplier risk can be a challenge. Do you understand your organisation’s total exposure to a supplier? Obtaining timely and relevant information can be a problem and depends on several factors, including:

- Strength of relationships
- Level of influence/control
- Local rules on financial information provision
- Cultural and behavioural habits

The supplier failure risk management process needs to be flexible and work with or without the direct co-operation of suppliers. It must go beyond basic financial assessment.

### Levels of maturity

- **Reactive**
  - Public information (e.g. filed accounts)
  - Limited communication
  - Limited provided by public information providers

- **Proactive**
  - Regular information provided by suppliers and reviewed by customer
  - Bespoke monitoring systems
  - Supplier assessments/diligence

### Vontik - a tool to help you identify troubled suppliers

Vontik is KPMG’s web-based business intelligence tool, specifically developed to help companies identify troubled suppliers and deal with them before value is destroyed.

**Benefits to the client**

Used as part of a structured process, it allows clients to identify potential risky suppliers in a timely manner – reducing the cost and risk of reacting to failure.

It allows clients to focus on using knowledge obtained as opposed to the collection and evaluation of data.

**Benefits to suppliers**

Provides benchmark comparisons across customers, industries, and within product categories.

**Key features**

Vontik provides a platform to efficiently exchange information with suppliers, empowering organisations with value-added analytical tools to proactively manage supplier failure risk.
Mitigating the risk of supplier failure

At its best, supplier failure risk management must be an iterative and continuous process enabling you to identify, monitor and plan for potential disruption across your organisation.

What you can do?

**Work with current suppliers**
- Ensure a high level of open communication and co-operation between you and your suppliers
- Where appropriate, consider the need for short term support and assistance (operational and financial)
- Open-book contracts

**Continuous improvement**
- Improved risk assessment in supplier selection process
- Invest in business critical suppliers
- Continuous monitoring process
- Education and training of buyers/supply chain teams
- Broaden your assessments to include secondary and tertiary suppliers

**Contingency planning**
- Stress testing of suppliers financial and operational strength
- Scenario planning
- Develop and implement appropriate contingency plans
- Where applicable, implement dual sourcing
- In-sourcing
- Increase buffer stocks
How can we help?

KPMG offers a suite of services to assist you in managing the risk of supplier failure. Our services can be tailored to meet your specific requirements, depending upon how sophisticated your existing systems and processes are and the level of risk you have in your supply chain.

**Identify and monitor**
- Independent assessments of your existing processes
- Facilitate the development of information packs and subsequent monitoring of the data
- Detailed supplier assessments
- Ongoing monitoring support to compliment your existing systems
- Implement and support Vontik
- Contract compliance reviews

**Mitigate**
- Contingency planning support
  - Critical review of existing plans
  - Preparation
  - Stress testing
- Stressed and Distressed Supplier management
- Advice on global restructuring and insolvency regimes
- Advice on dual sourcing procurement best practice
Client case studies

KPMG is retained by major global and regional companies to advise on a range of sectors including automotive, consumer goods, industrial products, oil and gas and service sectors.

**Automotive OEM**

**The challenge:** To provide a system to identify stress within over 1,000 suppliers and provide options assessment to deal with the problems.

**Work performed:** This OEM sponsored a Vontik network. KPMG’s professionals worked with the OEM to identify those suppliers most at risk of failure using a tailored dashboard. KPMG has undertaken individual in-depth assessments of those suppliers deemed most at risk to quantify the potential for failure.

**Outcome:** the client has a clear view of its most distressed suppliers and is working through the options available to reduce the risk of supplier failure.

**Food service distribution**

**The challenge:** Our client was facing potential significant damage to its reputation if a key logistics supplier failed to deliver food to a network of hospitals and schools.

**Work performed:** KPMG performed a rapid assessment of the suppliers financial position to determine the extent of the problem. Once determined, we helped our client to formulate a plan to ensure the supply chain was not disrupted.

**Outcome:** Our client provided short term financial assistance to its supplier to buy enough time to allow for a smooth transition of the supply contract to an alternative supplier.

**Major energy company**

**The challenge:** A major energy company was starting to develop new revenue streams through strategic capital investment programs when a key supplier of equipment ran into difficulty.

**Work performed:** KPMG undertook an external analysis of the suppliers financial condition to determine the options available to keep the capital project on track.

**Outcome:** We developed a plan for our firms client to accelerate certain payments to allow the supplier to meet its delivery goals and install the equipment on time.

**Electronics company distribution network**

**The challenge:** Our client was losing money supporting its distribution channel, which it operated on a licensee basis and was also having its global brand damaged through poor customer service.

**Work performed:** While not focussing on suppliers, the issues encountered in the distribution network were the same as in the supply chain. KPMG reviewed the operation of over 100 licensees to assess the financial strength of each one and determine the potential cost to our client of either continued shop closures or additional financial cost to support the underperforming licensees.

**Outcome:** A strategy was developed to rationalise the licensee network and transfer licensees to the largest and financially strongest operators. This minimised the financial assistance required and maintained a strong network of branded shops.
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