Managing supplier risk post Covid-19 including financial viability (VIRTUAL) Weds 12th August 11am – REPORT

As we emerge from the pandemic, it will become increasingly obvious just how many suppliers are struggling to survive in the 'new normal' after a desperate lockdown period – especially SMEs.

So, how, exactly can we tell when trouble may be brewing within our supplier base? Both for existing suppliers and new vendors? How can we ensure their financial viability today?

Moreover, where do our opportunities lie in gathering the core data that helps us tale a rounded view of new suppliers and their levels of stability?

Most procurement teams use the on-boarding process reasonably well; but do you capture all the information you should at a key time for compliance and reporting – and are we pre-qualifying suppliers well enough?

How could we better use the supplier on-boarding process to mitigate risk downstream? And what level of detail should we be applying to due diligence and supplier risk assessments post-pandemic?

Crucially, much of the information we truly want can be 'hidden' in the maze of their accounting – both within their published accounts and in their unpublished management reports.

But how do we make the most of these? Can we, in procurement roles, read financial statements well enough? What signs should we be looking for? What are the 'tells'? How do others do this?

Join this PASA CONNECT virtual Roundtable with the senior KPMG associates from the CFO advisory team, and learn how to read the basic messages from a set of accounts and then in the Q&A get to ask all those questions you have always wanted to ask but never had the confidence to

Your facilitators:

Jason Collins is a Director in the CFO Advisory team at major global accounting and advisory firm KPMG. Jason is a Chartered Accountant with a purpose of making finance functions better.

Samantha Durban is a Director and the Victorian Procurement Advisory lead at KPMG. Sam has over 20 years' experience in business process outsourcing and procurement advisory.

Managing supplier risk is best as a proactive endeavour. And RISK is the best lens to view supplier appraisal through. This has always been a part of the procurement process, but takes a much more meaningful role given the fragility of so many suppliers post Covid-19.

Using technology to review risk, then procurement intervention, then on boarding is a good three step process to use.

The primary risk was reputational before Covid-19, today other risks are joining the priority of that.

Key considerations to accelerate on-boarding

Below are examples of baseline considerations which should be reviewed before proceeding with further assessments of the supplier

Privacy
- Privacy Policy
- Data Breach Response Plan

Independence
- Connections to other parts of business

Security
- Information security policy
- Security Incident Response Plan

Legal
- What license agreement / contracts will have to be signed
- Can terms be negotiated

Third Party Integrity
- Involvement in countries where trade sanctions are in force
- Appearance on sanctions lists
- Public information search

Privacy
Independence
Security
Legal
Third Party Integrity

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And the considerations are much broader … especially financial viability of suppliers (mainly SMEs) …. This demands procurement are proactive and on the front foot more on supplier appraisal. Financial being the most telling early on, and increasingly the mandatory requirements too (MSA etc ..)

Supplier Due Diligence and General Compliance

Once the baseline requirements are satisfied, further information on the supplier should be gathered and analysed, for example via a questionnaire. This should cover variety of areas such as:

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Financial viability can best be assessed early through accounting analysis … this data can come from self-disclosure as well as ASIC reports, D&B reports, forwarded accounts and simply asking for it. The on-boarding process often requests some/all of this.

The first indicator is REVENUE – it should grow, not contract or dip. A dipping revenue line is very telling. Profit (after expenses) can be retained or distributed to shareholders – no profit indicates a very high risk of low financial viability usually. A dipping profit questions relevance, trends, market indication of competition.

The balance sheet indicates liquidity, as well as financial strength. Cash holdings should be several fold their typical monthly expenses. KEY RATIOS here are current assets/liabilities ratio.

Both the P&L (income statement) and the BALANCE SHEET are critical – and show different things … equally critical … as does the third key document, the cash-flow report.

Balance Sheet and Income Statement

Balance Sheet

A balance sheet is a snapshot of the business finances as it currently stands. It tells you about the assets that the supplier owns, and liabilities (i.e., debts) they owe, at a particular point in time.

Aside from providing information on what the supplier owns (assets) and owes (liabilities), the Balance Sheet outlines the value of a business to its shareholders. It can also be a general guide to supplier's size, based on value – small, medium, or large – which can be used as a barometer for future sourcing, development, and partnerships.

Examples of risk indicators

- **Long term assets** - Typically for stable suppliers, little to no change is expected. Great fluctuations might indicate that the suppliers are undergoing rapid change, mergers, acquisitions, or divestitures.
- **High Loan Capital** – If the loan capital (money borrowed from lenders) exceeds the amount of share capital (investor funds), this means the Supplier has a large amount of loan payments that they are obligated to pay. This can have a negative impact on cashflow and profit margins, putting the business in an unstable financial position until the debts are reduced or cleared.
- **Current Assets to Current Liabilities ratio** - measures supplier's ability to pay short-term and long-term obligations to their suppliers (your Tier IIs). If your suppliers can't pay their suppliers consistently over time, you could experience supply disruption delays/stoppages, one potential warning sign of this issue, as a result.

Income Statement

Income statement shows you how profitable the business was over an accounting period, such as a month, quarter, or year. It shows the revenue (how much the supplier made) and expenses (how much the supplier spent).

Reviewing Income Statements can be insightful as to how suppliers earn revenue from various offerings and markets, and seeing their expenses and profit margins compared to competitors. A well-run, profitable supplier should be the goal.

Examples of risk indicators

- **Stability of Revenue** – If there are substantial fluctuations in revenue year on year this might indicate that the supplier's business is unstable. Ideally you would see a sustained growth, however fluctuations should be further investigated as they might also indicate seasonality of the business etc.
- **Profits** – The trend in profits over a few years is an indication of how the business is performing. Consistently declining profits might indicate poor performance of the Supplier which might impact their ability to provide goods/services in the future.
- **Unusual transactions** – A nonrecurring transaction can be a signal of important changes or financial difficulties (e.g. sale of headquarters). Any unusual items on the Income Statement might be worth further investigation. Look out for items such as gain on disposal, discontinued operation, assets held for sale.

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Understanding this is key to assessing financial viability … and *stability* of your supplier. Accounts are prepared on the basis that your supplier is a *going-concern*. This should be state in the auditor's letter - or whether there is a question on this? This would be a large RED FLAG. Detailed analysis of their accounts will reveal more.

The most telling indicator of stability is CASH. Low cash is the number one reason that organisations fail. Ideally, firms should have enough cash at hand to cover several months operating expenses. This is especially important is liabilities are greater than assets on the balance sheet.

So, the TOP 5 key factors and RED FLAGS to consider from the supplier's accounts …

1. **Do the auditor's confirm they are a going concern?**
2. **Is CASH high enough to cover the business expenses for months?**
3. **Are liabilities greater than assets?**
4. **Is REVENUE growing, even marginally?**
5. **Is profit stable or growing, or dropping?**

Press coverage (especially the AFR) helps keep tabs on major supplier's strength. Many company insolvencies are expected in the next few months. Many suppliers are vulnerable despite government support like JOBKEEPER – which have to be disclosed in financial reports.

Things are moving very quickly at the current time, staying in touch with supplier's risk levels is critical.

The key question for procurement managers today – is *how badly do you want to keep the suppliers you have, and what might you be prepared to do to keep them for the future?*

The next challenge, after the due diligence of the sourcing process, and the on-boarding process, is how can buyers helps? Fast payment, flexibility on terms, longer term commitments, volume guarantees and the like all help SME suppliers especially.

This also includes a process of waterfall questions on very key supplier:

a) Strategic considerations like re-shoring
b) Accounts analysis
c) Supplier appraisal visits
d) Thorough on-boarding process
e) What if … scenario planning
f) Dual sourcing options
g) SRM meetings with suppliers : openly discussing vulnerabilities
h) Event response teams on standby – just in case

Good contract management and SRM continues the process throughout the supply partnership.

If in doubt … ask your supplier a straight question. If they don't answer – it might tell you something. If they do, maybe we need to be prepared to help more?

Notes by JD

120820 Melbourne