

Detection and prevention of risk from third parties

Better safe than sorry



As companies' reliance on third parties (such as contractors, partners and suppliers) increases, the need to both detect and prevent risk from these third parties becomes ever more important. National legislation with broad international reach is increasing the acute risk of legal non-compliance and the associated impact on corporate reputation. A risk-based due diligence approach is required to detect and prevent these risks.

Relevance and best practices in third-party due diligence

Companies in many sectors – particularly construction, infrastructure operation, energy and telecoms – interact with a large number of third parties, including their customers, partners, suppliers (from subcontractors to material suppliers, utility suppliers and even financial entities) and commercial agents. A company may have an economic relationship with thousands of third parties each year and potential relationships with more than three times those selected in the same period (such as business opportunities which are not secured, suppliers from which quotations are sought but that are ultimately not selected). A standard map of third-parties can be found below.

Standard map of third parties



Source: Arthur D. Little

In some sectors – particularly construction – companies can critically depend on third parties. It is not unusual for over 90% of any given contract value to be passed on to these third parties. Some of the types of risk and potential impact that these third parties can bring include:

- If the third party has financial issues during the relationship, it can lead to delays in the work and overall contract delivery.
- If a third party behaves in an overly contractual or argumentative manner, it can lead to delivery delays, additional costs and often the need to dedicate more company resources to manage the third party.
- If a third party is involved in corruption cases (either real or alleged), legal liability may extend to the company and have reputational impact.

We predict that this situation will continue to increase in the coming years. For instance, major construction and infrastructure development companies are increasingly expanding their footprints into countries far from their "home markets." Major infrastructure development in the coming years will be carried out in emerging markets with potential for higher rates of return and lower levels of national debt. The third parties in these emerging markets tend to be less well known and could bring new risks. A number of countries where large infrastructure construction and investment are expected are highlighted in the following international rankings and lists of transparency indexes for their high levels of corruption.

Worldwide corruption indexes by country and sector



Source: Transparency International Bribe Payers Index

At the same time, national legislation covering corruption has tightened significantly – one example is the UK Bribery Act 2010, which has an international scope that applies to all companies with UK operations. Overall, regulatory trends increasingly make companies responsible for corruption and bribery carried out by their partners and third parties, with the related penalties and sanctions increasing and having transnational impact. For instance, sanctions include the loss of the company’s ability to undertake contracts in the legislation’s country of origin and the criminalization of its executives. Some examples of legislation can be found below.

Selection of international legislation – focusing on third-party liability

Selection of applicable international legislation		
Region	Name and year	Scope
	Convention on Combating Bribery – 2011	Relates to third parties over which it has effective control
	Bribery Act – 2010	Art. 7: “An organization is guilty if a person associated with the same bribes...”
	FCPA – 2004	“An organization is guilty for making a payment to a third party knowing that...”
	Criminal code amendment – 1999	Art. 24: “...If the payment is carried out by the organization or on behalf of a third party...”
	Bill S-21 – Act concerning corruption of FPO	Art. 3: “...to obtain an advantage, directly or indirectly, pay a bribe...”
	Ley 10/2010/28 April Código Penal – 2015	The civil code includes liability regarding third parties

Possible sanctions

- Criminal liability of executives
- Prohibition on undertaking contracts in certain countries (e.g. US, UK)
- Fines or penalties of economic nature
- Property confiscation

Principles of action required to mitigate responsibility

- Developing systems for detection and prevention of risk from third parties
 - Evaluation of the nature and the scope of the risks
 - Proportional measures to existing risks
 - Implementation of prevention and detection systems

Source: FCPA, UK Bribery Act, other regulation, OCDE

Additionally, the growing participation of international development funds in infrastructure projects also increases risk, as they tend to be more severe than national governments when imposing sanctions or penalties.

In summary, the world is becoming an increasingly complex place for international companies to operate. One example of evidence of this statement is that in only 10 months out of 2015,

there have been 10% more corruption cases than in all of 2014, according to the US Securities and Exchange Commission.

However, companies can take steps to mitigate, manage and even create value from this situation. In particular, companies are increasingly using detection and prevention approaches to detect, avoid and manage risk. There are three major benefits to this approach:

- First of all, it allows early identification of potential economic risks. These include financial weakness from a partner or a payment default by a customer, technical issues such as conflicts or delays in recent projects, and compliance issues such as convictions or recent cases of corruption. Early identification of potential risks improves the company’s position when negotiating with third parties and can create significant value.
- Companies that perform and keep records of their third parties can mitigate their liability if cases of corruption arise afterwards. In some recent cases, companies involved in corruption that were able to prove that they had detection and prevention systems in place were able to reduce their sanctions significantly.
- It allows cost optimization, particularly during the business development phases. Preparing bids represents a great cost for the company not only in terms of allocation of its own and external resources, but also in terms of the opportunity cost of allocating those resources to activities that may be more profitable or have lower risks. The ability to detect counterparty risks in advance implies better allocation of resources and better business decisions.

However, the implementation of an adequate detection and prevention system for third-party risk is a complex task in its own right, for the following reasons, among others:

- Construction and infrastructure are among the sector more exposed to corruption (as could be observed in the rankings illustrated before), and this activity increasingly takes place in countries and regions with low transparency according to international organizations.
- Practices and legislation vary between countries, leading to different ways of doing things. For instance, some intermediary business practices that are common in certain parts of the world are not legal in other countries.
- Excessive processes and bureaucracy can significantly reduce agility and become a competitive disadvantage for companies.

Arthur D. Little has worked on the design, development and implementation of systems to deliver third-party due diligence. Our approach aims to answer the following three questions illustrated below:

Arthur D. Little approach to third-party due diligence



Source: Arthur D. Little

In our experience all major international construction companies and developers of significant infrastructure projects carry out assessments of their third parties, or at least of some of them. However, this is usually conducted in an unstructured way, without standard procedures, leading to time and cost inefficiencies. To ensure effective and efficient assessments, the following guidelines have great value in the design of third-party due diligence systems.

Necessary elements for effective third-party due diligence systems



Source: Arthur D. Little

Based on our experience, we have identified the following key success factors for successfully implementing a detection and prevention system:

- **Holistic perspective:** The due diligence process should include all major risk compliance.
- **Risk orientation:** Focusing analyses only on higher-risk situations. From a compliance perspective, legislation provides the guidelines for selecting the third parties to be

assessed. From a technical and financial perspective, volume and criticality of the third party to the company must be the guiding principle.

- **Proportionality:** The dedication of resources and depth of the analysis must be adequate. Construction companies are not international intelligence agencies, which means that the added value of the assessment should be higher than the costs of carrying it out, as in any other business.
- **Independence and objectivity:** The information included in the financial and technical assessments must be provided independently and objectively. For example, the compliance and financial perspective should be performed by independent units as, for instance, business development teams tend to be more optimistic about third parties than other teams.
- **Leverage all available sources of information when assessing third parties:** Reports from reputable sources or institutions bring transparency and credibility, but must coexist with opinions and experience of staff within the organization. There must be a defined methodology for selecting information that assures its traceability and maintains confidentiality.
- **Aimed for decision-making:** The due diligence analysis of the third party is not intended to “veto” its selection, but should help to decide which third party to select. Only in extreme cases (for example, imminent bankruptcy or presence on an international sanctions list) should the possible relationship with the third party be vetoed based on the due diligence analysis.
- **Willingness to anticipate:** The effort associated with bid preparation and procurement processes is very high, which means that the earlier the assessment is carried out, the earlier the company will make a decision about the third party, and it will avoid incurring unnecessary costs associated with a potential third-party relationship that is too risky.
- **Easy assessment criteria:** Criteria have to be easy to apply so that risk level is not a factor subject to interpretation. For example, a criminal conviction of a third party’s executive is a serious issue, but it is not the same if the conviction took place five or twenty years ago. Establishing clear and straightforward criteria and standards on risk adoption needs to be efficient. Risk appetite needs to be a company decision, not a decision that depends on the risk aversion of each employee.

Concluding questions

Arthur D. Little recommends putting in place detection and prevention systems, especially for companies in certain industries, to achieve the following benefits:

- Improve the selection of third parties, which ultimately will lead to higher company valuation, as it is the straightforward consequence of having more trustworthy customers, partners and suppliers.
- In the case of being involved in a corruption incident involving a third party, the company would be able to reduce its liability and exposure by providing evidence of having risk detection and prevention systems in place.
- Help create a stronger company culture in risk management.
- And last but not least, the costs of developing such systems are, in Arthur D. Little's experience, far lower than the cost of liability, which makes it an attractive value creation opportunity.

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Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients to build innovation capabilities and transform their organization.

Our consultants have strong practical industry experience combined with excellent knowledge of key trends and dynamics. Arthur D. Little is present in the most important business centers around the world. We are proud to serve most of the Fortune 1000 companies, in addition to other leading firms and public sector organizations.

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