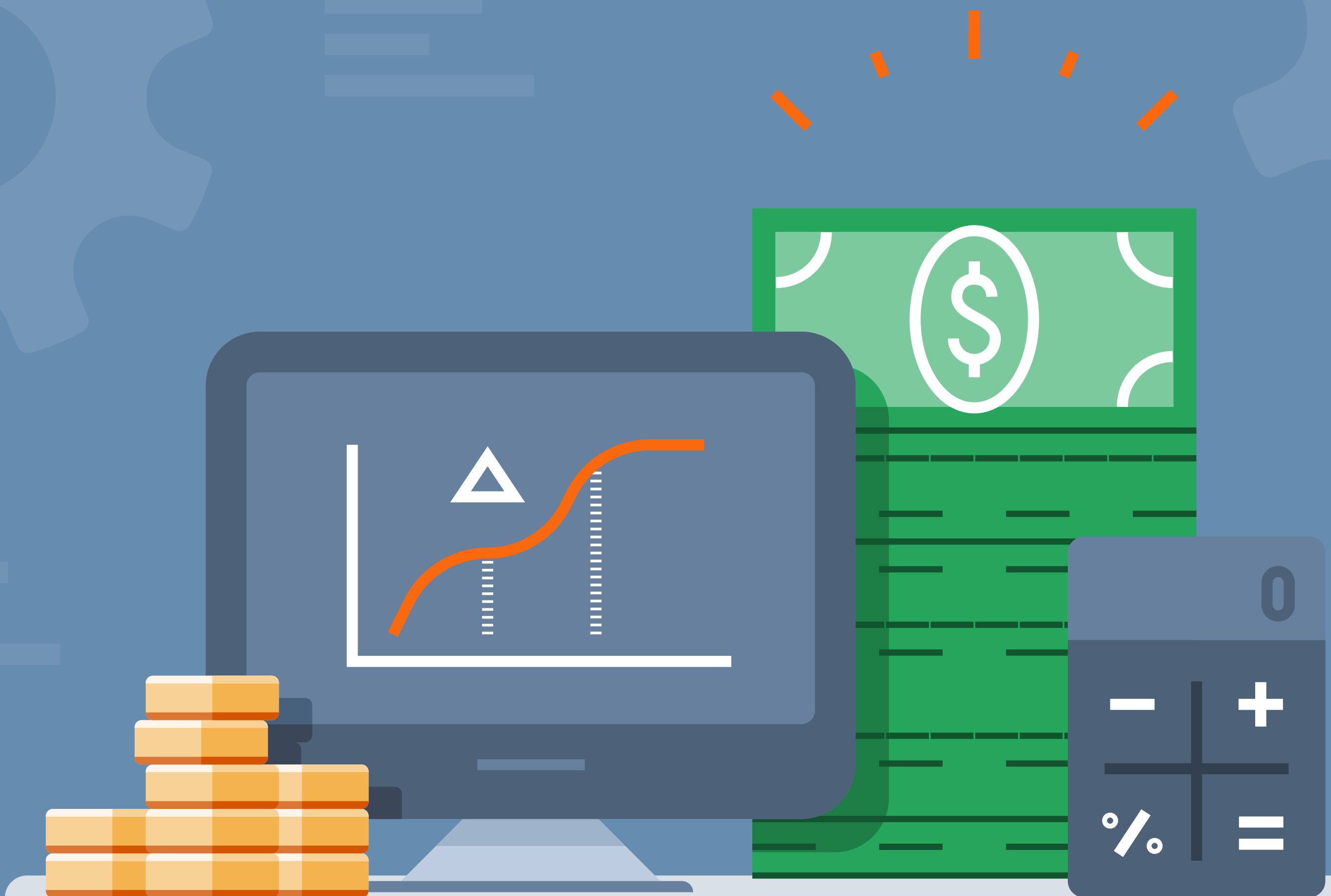
THE IMPORTANCE OF

Vendor Financial Performance



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The Importance of **Analysis**

It's always surprising how few organizations are prepared to complete a true financial analysis on their outsourced vendors. All federal level regulatory agencies now require an organization to understand the financial health of vendors and suppliers with whom it contracts for services and products. To be clear, collecting a financial statement from a vendor isn't enough. The process must include analyzing the vendor's financial health to determine the vendor's capacity to continue to provide safe, secure and quality products/services at the level you require.

This should not be considered an extra item to do when there is spare time, but rather a regular part of the organization's due diligence.

Per the FFIEC IT Examination Handbook:
"Due diligence should serve as a verification and analysis tool, providing assurance that the service provider meets the institution's needs."

The guidance is clear, but even more importantly, the health of your vendor, especially critical vendors, is a vital part of your overall risk management process and ultimately may affect your own reputation.

After all, a vendor's financial health affects how the organization operates and the amount of success it will achieve.

3 key items to investigate when analyzing a vendor's financial status should be:

- 10-Ks or annual reports
- Changes in revenue or assets/liabilities
- The impact of mergers and acquisitions

Performing an Accurate Assessment of the Vendor's Financial Performance

It's essential to obtain an accurate financial performance assessment of your vendors. Consider the following when performing an assessment:

1. **Do they have the revenue and/or have sufficient capital to support their ongoing operations?**
   This is the biggest driver of financial performance; if they are not making money, then they may not have the resources to improve their product or staff at appropriate levels for acceptable customer service levels.

2. **A company's net worth – are your vendor's liabilities exceeding their assets?**
   While this might not always be a red flag, it's important to understand the impact of a company's liabilities, especially if there is a trend of increasing liabilities from year-to-year. When liabilities are elevated, it's important that the vendor has a plan and sufficient resources to tackle them.

3. **Cash, and especially their current ratio, are other areas to look at.**
   This will help determine if they can sustain their operations at the current level and over the course of the next year.

4. **Inspect their debt-to-worth.**
   And, when applicable, research what outside rating agencies, such as Moody's, Standard and Poor's, or Fitch, have rated their debt obligations. Also, take note if the ratings have either been upgraded or downgraded in the past 12 months.

Why Revenue Increases **Aren't What They Seem**

Revenue grew so the vendor's financial performance improved, right? Wrong. Well, maybe. It depends on how much or how little that revenue grew. And more importantly, was it organic or was it through acquisition?

One of the key components to financial performance is the gross margin—are costs increasing faster than revenue? The problem with this is that a lot of companies don't disclose their gross margins, so it's a little harder to determine. Therefore, the organization should look at operating income to determine the company's performance. Even though its revenue might have increased, the operating income will show whether or not performance has improved.

And, the real tell on this is the area called "comprehensive income." Through that analysis, the organization can see items that might not be discovered by just looking at the balance sheet or income statement, such as foreign exchange translations.

3 Areas in a Vendor's 10-K to Look Out for

The 10-K is formatted identically for all publicly traded companies. There are three areas to look out for:

First, look at risk factors. These are outlined in detail with special note to any regulatory action that might have occurred.

Next, look for any legal proceedings or lawsuits that are pending, along with the estimate of the anticipated settlement charges.

Finally, look at the auditor's opinion. Look at their opinion on financials, especially on comprehensive income, and their assessment of the adequacy of the internal control.

The Domino Effect of Declining Vendor Financial Performance

When companies have declining income, they typically all react the same way. They cut cost. What's the fastest way to cut cost? By cutting staff. What follows staff cuts? Declining service levels. And, that's not just defined by how long it takes to answer the phone or call you back. Cost reductions in the operations area will also likely mean a decrease in staff who are charged with maintaining the security and integrity of the system. That's when your organization could find itself at a heightened risk.

You'll also likely find a significant reduction in spending on product development, a legacy product being sunsetted or a sale pending on a poorly performing product or operating division. This could result in bugs, unresolved issues, long waiting periods, downtimes and more.

Unfortunately, lack of financial performance isn't typically included as a condition for termination of a vendor contract. Even if the financials are frightening, contractually you can't get released from the contract because it's not defined as a default. Therefore, the Service Level Agreements (SLAs) become incredibly important. Product managers need to begin paying particular attention to the contractual SLAs during a period of poor or declining financial performance; they are absolute key to managing the vendor, assessing your risk and developing a "what if" scenario. While poor financial performance won't trigger a default, your SLAs can.

Thoroughly Analyzing the Numbers Will Help You Discover Weak Financials

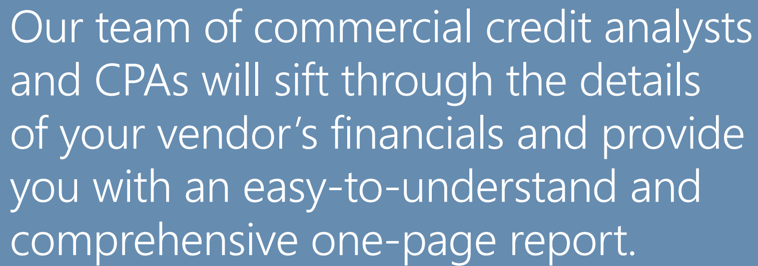
Weak financials may indicate underlying issues such as:

- Loss of business
- Litigation and bad press
- Decline in service levels
- Inability to retain internal expertise
- Loss of key management
- Slow pay problems resulting in service level gaps or a decline in product quality
- Lack of infrastructure support and future development of innovative technology

Understand the Financial Health of Your Vendor

It's essential that you understand the financial health of your vendor. Remember the following:

1. **It's required by regulation.**
2. The analysis must be done by **qualified subject matter experts.**
3. **Decoding a 10-K can be challenging.** Ask for help if you need it.
4. **Don't treat financial reviews as a check-the-box exercise.**
5. Don't let the **domino effect** of declining financial performance surprise you.
6. **Assess your risk** and escalate or monitor accordingly.
7. **Understand your options** and **develop a plan** when necessary.



Our team of commercial credit analysts and CPAs will sift through the details of your vendor's financials and provide you with an easy-to-understand and comprehensive one-page report. **Download a sample of our vendor financial health analysis.**

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About Venminder

Venminder is a leading third party risk management provider dedicated to helping the financial services industry mitigate vendor risk.

Venminder's team of due diligence experts offer a suite of services that can significantly reduce the workload by addressing the tactical challenges of vendor management tasks. Venminder's vendor management software can guide a user through critical processes such as risk assessments, due diligence requirements and task management.

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