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Performance Improvement & Risk

# Internal Audit perspectives.

Increased level of supply chain risk joins  
growing chain of challenges

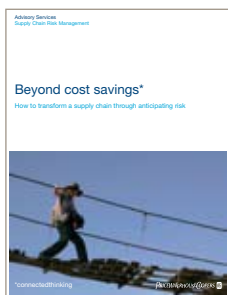
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### Related publications:



*10Minutes on supply chain risk management*



*Beyond cost savings: How to transform a supply chain through anticipating risk*

The current global financial crisis has many businesses grappling at the enterprise level with critical issues including financial stability, risk management, and sustainability. In these times, not much escapes scrutiny as companies scramble to dot i's, cross t's, and continue to run their businesses—all while cutting costs. Amid this urgency for smarter operations, managing the array of risks associated with supply chain should have a place on corporate critical-issue to-do lists. And, as should be expected, Internal Audit functions are actively assisting business leaders as your company works to manage its increasingly complex and pervasive supply chain risk.

It's not just about quality and cost these days. Supplier disruption can immediately and significantly affect profitability, impair growth opportunities, shatter shareholder value, and compromise reputation through a decreased level of public confidence. A PricewaterhouseCoopers (PwC) analysis shows that businesses that experienced supply chain disruptions experienced steeper shareholder value drops than their peers; more intense stock price volatility; and deeper declines in return on sales and assets.<sup>1</sup>

### Be prepared

Today's deeply connected global economy and the drive to cut costs bring additional challenges to the risk control imperative. Global political instability, weather and climate

changes, pandemics and other health crises, and cultural gaps can cause supply chain disruptions and failures that can tarnish a business's reputation and eat away at a company's value.

In an era in which consumers seek nearly instant, on-demand goods and services, breakdowns in complex global supply chains can result in launch delays and product recalls—all with regulators, consumers, and other stakeholders observing it all through a more sharply focused lens. While many developing countries operate under less stringent production, legal, and intellectual property protections, US companies are applying greater regulatory scrutiny to business operations and supplier integrity. In one instance, a global automotive manufacturer experienced significant losses because some of its suppliers went bankrupt and others delivered poor quality products or were unreliable about meeting deadlines. In response, it began paying closer attention to the business environment in which its suppliers operated. It identified leading risks suppliers faced and conducted risk-adjusted evaluations of its suppliers' pricing proposals. As it turned out, the lowest bidder did not generate the greatest savings after the bid was adjusted for risk. The manufacturer now makes more informed supplier-selection decisions and is able to identify troubled suppliers quickly and take early corrective action.

<sup>1</sup> From vulnerable to valuable: how integrity can transform a supply chain  
Achieving operational excellence series, PwC 2008.

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## Holistic healing

Your company can begin to better understand its overall supply chain risk by embracing a holistic approach to cutting its supply risk exposure—one that's based on a comprehensive model that helps identify and assess vulnerabilities throughout the supply chain lifecycle. The first order of business should be to identify suppliers most critical to the company, taking into account high-level considerations regarding reputation, governance, operations, strategy, and brand. Then ask:

- Are there areas where we are risking more than we're saving by relying on this supplier?
- Which suppliers would cause critical operational problems if they were to default?
- What would be the likely financial impact of a critical operational issue/disruption to our operations?
- How vulnerable or viable is each supplier?
- How do our supplier's operations, as reflected by its quality and economics, align with our business goals and brand?
- Does the suppliers' integrity, as reflected by social, labor, environmental, and ethical underpinnings, align with our business goals and brand?

## Building a base to cover your bases

To enhance supply chain integrity, companies should develop a framework for a structured approach to ongoing risk identification and management. This will enable businesses to proactively address organizational supply chain risks on a periodic basis—a practice that affords stronger company and brand protection against supply chain risk gaps.

A successful supply chain risk management program requires characteristics of a newly structured approach:

- A comprehensive supply chain risk profile
- Established risk tolerances by type of risk, supplier, commodity, etc.
- A clear understanding of the true cost (direct plus indirect) of supply chain risk events
- Leading key risk indicators (KRIs) along with risk scoring models that give “early warning” to potential trouble
- Pre-defined management responses corresponding to increased levels of supplier risk
- Risk-based pricing and performance analysis to support improved risk response development
- Alignment of individual incentives to risk-based decisions
- A focus on early intervention rather than crisis management

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Internal Audit can work with the business leaders to develop an appropriate supply chain risk management program using some of these characteristics, as well as provide assessments of the supply chain risk management program through continuous monitoring and auditing.

Your company should also perform assessments of suppliers' financial information to gauge their solvency and stability. Because it is cost-prohibitive to assess every supplier, we recommend leveraging your processes and key risk indicators to identify any troubled suppliers within the supply chain before they become onerous. This may also include assessing the suppliers in a tiered approach to rank the risk level of each supplier.

## How Internal Audit can help

Internal Audit can contribute to your company's security and success by:

- Reviewing and understanding supply chains, including their strengths and weaknesses, in developing markets,<sup>2</sup> to validate monitoring programs
- Working with the company's supply chain specialists to help develop a monitoring process that can be repeated
- Helping to identify which suppliers are critical
- Assessing which suppliers may be vulnerable to threats and helping draw up a residual mitigation profile
- Identifying strong risk control procedures
- Helping to develop key analytic tools and techniques
- Aiding with compliance monitoring

Once these programs are implemented, Internal Audit can monitor their effectiveness and provide insights to guide the organization to ongoing, sustainable improvement. These are more than precautionary and damage control measures for today. They set the course for smart positioning for tomorrow's global business environment.

Companies doing business in emerging markets will look sharp in the years ahead if they meet the supply chain integrity challenge now. Distantly emerging markets beckon and are likely to present even greater potential supply chain risks—and business opportunities—over time.

<sup>2</sup> Brazil, Russia, India, China.

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Right here, right now. Your source:

For a deeper discussion about how Internal Audit can help management better monitor its supply chain risk, please contact:

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