

Managing Vendor Risk

By Ellen Adelson

In the current economic environment, hospitals may be looking for ways to increase revenues or reduce their costs and may be considering outsourcing some of their functions to a third party. Managing business risks of all types is extremely important, but risks related to critical vendor relationships are often overlooked. Here are suggestions for a formal risk management program for key vendors.

Perform a Risk Assessment

The first step is to perform a risk assessment. Hospital management should analyze the risks related to utilizing a vendor to perform services. The areas of risk that should be considered include:

- Strategic risk (causing your company to make adverse business decisions)
- Reputation risk
- Compliance risk (HIPAA privacy or security)
- Operational or transaction risk (potential interruption of service or product delivery)
- Credit risk

Once the risks are understood, management should attempt to forecast the revenues or cost savings that a vendor relationship would assist them in realizing. With this information, hospital management can determine if the risk of utilizing the vendor is worth the reward.

Perform Vendor Due Diligence

The second step is to perform due diligence on the vendor. It is helpful to identify the vendors available in the marketplace and compare their offerings. For significant engagements, it is wise to ask for a written response to a Request for Proposal, which outlines the vendor's ability to meet minimum requirements. This means that a team at your company must spend time developing detailed business requirements. Although difficult in these days of lean staffing, development of a business requirements document is key to vetting potential vendors and insuring that those selected meet minimum service or product needs.

Once a particular vendor has been compared to others and has been selected, more in-depth due diligence on the vendor can be performed. The following are suggestions for questions to ask and areas to investigate:

- **Can the vendor provide financial statements, and have these statements been audited?** Are Dun & Bradstreet or other sources of financial information available? It makes no sense to sign a three-year contract with a vendor whose lack of cash reserves may drive them out of business within six months. If resources within your company are not available to evaluate the vendor financial statements, can you obtain the vendor's permission to have an outside party review them?

- **Would the vendor's current staffing model be sufficient to support your business needs?** If not, it is important to understand how the vendor plans to grow and if qualified personnel are available to work on your engagement. A vendor who is stretched too thin will not be able to meet your expectations for performance.
- **Investigate the vendor's business reputation by checking references.** The Better Business Bureau, state Attorney General offices, state consumers' affairs offices, and, when appropriate, audit reports and regulatory reports can help you to determine whether there have been complaints or litigation.
- **Review qualifications, backgrounds, and reputations of company principals.** How long have the principals been in this business? What are their reputations in the industry? This is particularly important for smaller vendors, where the management team will strongly influence the company's culture and performance.
- **Ask your internal audit team to review the vendor's internal controls environment and audit coverage.** This might simply be a conversation between an auditor from your company and an auditor or manager from the vendor, or a review of written policies and audit findings. Some vendors may be able to provide you with a SAS 70 report, which is an independent assessment of their internal controls, or other accreditation reports that would provide assurance that controls are adequately designed and are operating effectively.
- **Ask your MIS management team to review the adequacy of the vendor's management information systems.** If you are purchasing technology services from this vendor, the review should include detailed written documents discussing such subjects as user authentication, firewalls, system redundancy, and software versions used. Your MIS team probably has documentation and policies for internal systems that can be used to develop vendor assessment tools.
- **Review a written business resiliency plan provided by the vendor.** If the vendor cannot provide at least a written overview of a business resiliency plan, with the option of a follow-up conversation with the business resiliency team, then you should consider whether it is prudent to do business with the vendor. Also, does the vendor specify what their Recovery Time Objective (RTO) is? It is important that their RTO would meet your business needs; otherwise, you will be unable to meet your commitments.
- **Discuss the vendor's technology recovery testing efforts, if the service or product to be provided is dependent on technology.** Does the company have hot and cold recovery sites? Are disaster recovery plans tested? As a client, can you participate in, or observe, annual tests?

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- Ask the vendor to identify any subcontractors that may be used to provide the service or product. Are off-shore subcontractors used? If so, has the vendor evaluated legal and country risk for these subcontractors? What is the vendor’s history in working with subcontractors? In the event of a subcontractor failure, what backup plans does the vendor have? If the vendor is heavily reliant on subcontractors, you may need to consider whether to conduct a risk assessment for major subcontractors in addition to the primary vendor.
- Does the vendor have adequate insurance coverage? It is common practice to request certificates of insurance coverage when engaging a new vendor, and to request updated certificates on an annual basis.
- Do the vendor’s strategies, business goals, service philosophies, and approach to quality match those of your company? Major differences in corporate culture may cause problems later in the business relationship. Although these differences may be qualitative, and thus hard to measure, it is worth spending time talking to the vendor about how they handle different types of issues and probing possible areas of difference. As an example, if your patient services area has a goal of responding to patient inquiries within the same business day, and your new collection company won’t respond to a call faster than 48 hours, you can expect immediate conflicts to arise. It is a good idea to take some time to consider the service levels you would expect the vendor to meet.

Depending on the responses given to these questions and requests for information, the hospital may make the decision not to pursue a vendor relationship. Alternatively, the hospital may realize there is risk to the vendor relationship but still want to move forward with engaging the vendor. It is important for hospital management to have a plan to mitigate the vendor’s risks and, if the risks are deemed to be high, hospital management should develop a contingency plan so that they are prepared in the event the vendor fails to perform.

Enter into a Contract with Vendor

The third step is to enter into a contract with the vendor. Hospital management should ensure that the services being provided are fully described in the contractual documents. This helps prevent issues from arising down the road if there are areas of confusion as to what is in or out of the scope of the engagement. Other areas to consider include:

What is the term of the contract? If services are being performed, the term will usually be for a finite period. It is typical for software licenses to be perpetual.

What are the notification and termination provisions? If you have come to rely significantly on a vendor, it is advisable to make sure that the vendor gives you adequate time to find an alternative service provider if the contract is terminated.

Are there specific items outlined in your contingency plan that you need the vendor to provide? For example, if you are relying on software from the vendor, you may want to consider having the vendor escrow the source code. In the event that the vendor becomes insolvent and can no longer provide maintenance and support services, you would then have the ability to

access the source code and maintain it yourself.

Are there items (e.g., financial statements, certificates of insurance, etc.) that you reviewed during the initial due diligence that you would like the vendor to provide periodically? Those items should be specified in the contract, as well as the frequency in which you expect to receive them.

Are there performance standards that you need the vendor to meet so that the hospital can meet service commitments? These performance standards should be clearly documented in the contract.

Implement Periodic Review of Vendor

The fourth step is to implement an oversight or periodic review of the vendor. This monitoring will help confirm that the vendor is performing, or alternatively, will allow you to identify weaknesses that need to be resolved or, in a worse case scenario, trigger implementation of the contingency plan. Periodic monitoring should include, but is not limited to, the following:

- The vendor’s financial health should be reviewed on a frequent basis. In addition, are there services you can subscribe to that may notify you of changes to the vendor’s financial health?
- The questions asked and documents reviewed during the initial due diligence should be refreshed on at least an annual basis by the vendor. Hospital management should ensure that qualified employees review these materials and assess the vendor relationship.
- Per the contract, is the vendor providing monthly or quarterly reports demonstrating their ability to meet the defined performance standards?
- An in-person meeting should take place on a periodic basis to review the vendor’s performance, address any issues, and ensure that the strategic direction that the vendor is pursuing aligns with yours.
- Periodically check in with your vendor relationship contact to determine if any key employees have left the company. If there is significant turnover, it is often an early warning indicator that the company is experiencing problems. Has the vendor made any public announcements about restructuring or closures of business lines? Hospital management should follow-up on those announcements to make sure there is no detrimental impact to the service being provided by the vendor.
- As changes take place in the industry, particularly related to regulations, discussions should take place with the vendor to ensure the vendor makes the appropriate changes for compliance.

Vendor risk can never be completely eliminated. However, when risk is properly managed, the use of vendors can be very effective in helping hospitals increase service revenues or reduce costs.

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