Third Party Financial Assessments

Using a Comprehensive Approach to Spot and Mitigate Problems

TPRA Fall Virtual Conference

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Topics We'll Cover Today

1. The value of performing financial assessments on third parties
2. Three ways to assess a third party's financial health
   - Financial statement analysis
   - Risk intelligence analysis
   - Due diligence questionnaire analysis
3. Practical tips for assessing & mitigating financial risk

The Value of Performing Financial Assessments

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What is a Financial Assessment of a Third Party?

The process of assessing a third party's near- term stability and long-term viability.

Signs of strong financial health include:

- Positive cash flow
- Growth in revenue & profitability
- Appropriate level of debt
- On time payments to creditors/vendors
- Diverse customer base
- Low turnover/stability

Why Third-Party Financial Assessments Are Important

Ensure your vendors and other third parties are stable.

- Operational continuity
- Fiscal management
- Regulatory compliance

Client Story

Critical Vendor > Underwriting Services

July 3rd
Vendor:
"Go home early for the holiday!"

July 4th
Vendor:
"We are out of business."

July 6th
Client:
"How will we process underwriting?
Where is our data??"

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Which Third Parties Should You Assess?

Focus on vendors and other third parties that are truly critical to your operations and difficult to replace.

- Provide outsourced services
- Process transactions and/or generate revenue
- Provide important technologies
- Support other critical functions

Three Ways to Assess a Third Party's Financial Health

Financial Statement Analysis

Financial Statement Analysis

Overview

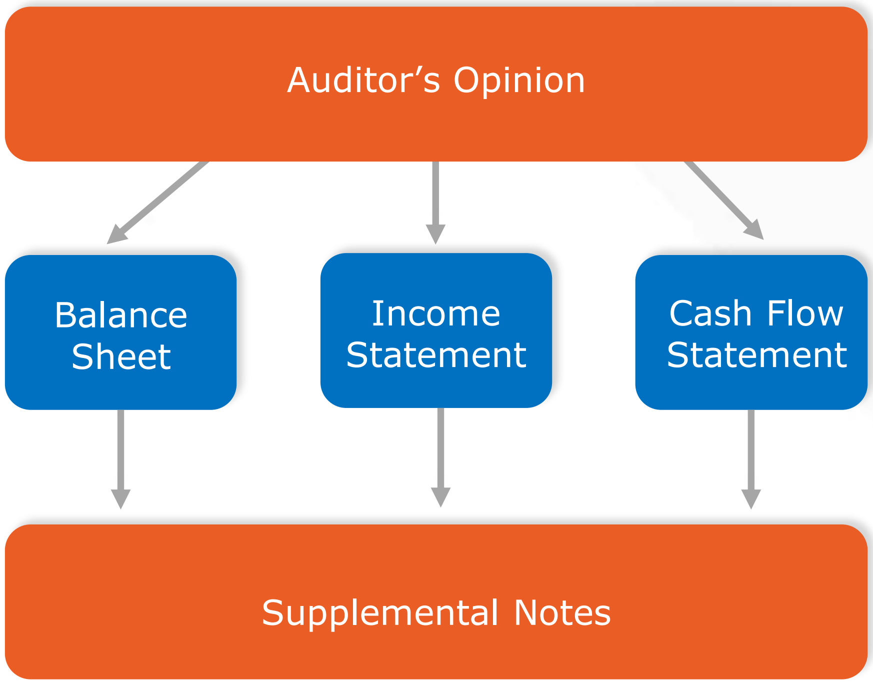
The process of analyzing a company's financial statements to evaluate their performance and financial health at a *previous point in time*.

Types of financial statements:

- Audited
- Reviewed
- Compiled
- Internally prepared

Financial Statement Analysis

3 Main Sections of Audited Financial Statements



Financial Statement Analysis

Independent Auditor's Report

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of the adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, as described below, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $______ and $______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $______ and $______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect

Source: PCAOB Website

Spot issues identified by the auditors.

Red flags include:

- **Qualified Opinion**
  we audited everything except for…
- **Disclaimer of Opinion**
  we didn't have enough information to audit anything…
- **Adverse Opinion**
  we audited everything and it's not looking good because…

Financial Statement Analysis

Trend & Ratio Analysis

Assets	This Year	Last Year
Current assets		
Cash and cash equivalents	$ 10,000	$ 10,000
Accounts receivable	35,000	30,000
Inventory	25,000	20,000
Total current assets	**70,000**	**60,000**
Fixed assets		
Plants and machinery	$ 20,000	$ 20,000
Less decreciation	-12,000	-10,000
Land	8,000	8,000
Intangible assets	2,000	1,500
Total assets	**88,000**	**79,500**
		=
Liabilities and Shareholders' Equity		
Liabilities		
Accounts payable	$ 20,000	$ 15,000
Taxes payable	5,000	4,500
Long-term bonds issued	15,000	10,000
Total liabilities	**40,000**	**29,500**
		+
Shareholder's equity		
Common stock	$ 40,000	$ 40,000
Retained earnings	8,000	10,000
Total shareholder's equity	**48,000**	**50,000**
		=
Liabilities and shareholders' equity	**$ 88,000**	**$ 79,500**

Source: Quickbooks

Spot problems in the numbers.

Red flags include:

- **Cash Problems**
  Cash Flow from Operating Activities Trend
- **Too Much Borrowing**
  Debt to Equity Ratio Trend
- **Poor Sales**
  Gross Revenue Trend
- **Unprofitable**
  Operating Income Trend

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Financial Statement Analysis

Notes to the Financial Statements

Note 19. Concentrations of Credit Risk

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of trade accounts receivable. The Company sells its consumer products to a wide variety of retailers, including mass merchandisers, home centers, independent hardware stores, nurseries, garden outlets, warehouse clubs, food and drug stores and local and regional chains. Professional products are sold to commercial nurseries, greenhouses, landscape services and growers of specialty agriculture crops. Concentrations of accounts receivable at September 30, net of accounts receivable pledged under the terms of the New MARP Agreement whereby the purchaser has assumed the risk associated with the debtor's financial inability to pay ($146.6 million and $149.5 million for 2022 and 2021, respectively), were as follows.

	2022	2021
Due from customers geographically located in North America	53%	52%
Applicable to the consumer business	61%	54%
Applicable to Scotts LawnService®, the professional businesses (primarily distributors), Smith & Hawken® and Morning Song®	39%	46%
Top 3 customers within consumer business as a percent of total consumer accounts receivable	0%	0%

The remainder of the Company's accounts receivable at September 30, 2022 and 2021, were generated from customers located outside of North America, primary retailers, distributors, nurseries and growers in Europe. No concentrations of customers or individual customers within this group account for more than 10% of the Company's accounts receivable at either balance sheet date.

The Company's three largest customers are reported within the Global Consumer segment, and are the only customers that individually represent more than 10% of reported consolidated net sales for each of the last three fiscal years. These three customers accounted for the following percentages of consolidated net sales for the fiscal years ended September 30:

	Largest Customer	2nd Largest Customer	3rd Largest Customer
2022	21.0%	13.5%	13.4%
2021	20.2%	10.9%	10.2%
2020	21.5%	11.2%	10.5%

Source: Quickbooks

Dig deeper for other issues.

Red flags include:

- Going concern issues
- Concentration of risk
- Significant accounting policy changes
- Legal or regulatory issues
- Unusual or non-recurring items
- Related party transactions

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Financial Statement Analysis

Pros and Cons

Pros

- The numbers tell the story of the business
- Independent audits provide confidence

Cons

- One year doesn't tell the full story
- Not everyone is audited
- Your vendors may be unwilling to provide them

Risk Intelligence Analysis

Risk Intelligence Analysis

Overview

The process of using independent data – typically from a subscription-based tool - to identify existing or emerging issues related to a third party's financial health.

Risk Intelligence Analysis

4 Ways to Use Risk Intelligence Information

1

Supplement the evaluation of financial statements and/or DDQs to get the "full picture."

2

Use in place of vendor's financial statements when they are not available.

3

Stay informed of financial risks on a continuous or ongoing basis.

4

Identify issues to discuss during a business review with your vendor.

Risk Intelligence Analysis

Key Features

Key features typically include:

- Scores and/or ratings to help proactively identify risks.
- Guidance and additional context about risks.
- One-time reports that provide quick insights.
- Real-time alerts to ensure you receive relevant updates.
- Dashboards & reports to spot trends and evaluate data.

Risk Intelligence Analysis

Financial Risks to Look For

Risks to Look For

Payment Information

- Late payments (DBT)
- Inconsistent payments

Legal & Compliance Information

- Lawsuits
- Liens & judgments
- CFPB complaints & regulatory fines

Credit Information

- Low credit scores
- Reported high credit offered

Negative News

- Bankruptcy filings
- Turnover rates
- Money laundering offenses

Financial Health Metrics

- Revenue trends
- Cash flow trends
- Profit projections

Risk Intelligence Analysis

Pros and Cons

Pros

- Real-time information and trends
- Consolidation of data from thousands of sources
- Predictive insights that allow preventive actions to be taken
- Demonstrates good practice to auditors/regulators

Cons

- Overwhelming number of metrics and information
- Less reliable information for private companies vs. public companies
- Can be cost-prohibitive (depending on # of vendors monitored)

Due Diligence Analysis

Due Diligence Questionnaire Analysis

Overview

The process of reviewing responses to questions and analyzing source documents to understand and evaluate financial controls and operations.

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Due Diligence Questionnaire Analysis

4 Categories of Questions to Ask

1. **Financial Performance**
   Revenue growth, profitability, and debt
2. **Financial Management Infrastructure**
   People, systems, and reporting
3. **Legal & Compliance Issues**
   Regulatory audits, lawsuits, bankruptcy filings
4. **Operational Stability**
   Reorganization, layoffs, acquisitions/divestitures

Due Diligence Questionnaire Analysis

Pros and Cons

Pros

- Provides information you can't get from financials or risk intelligence solutions
- Enables deeper dive into 'proof' from source documents

Cons

- Cycle time to complete the due diligence process
- Point-in-time assessment of financial health
- Larger vendors may not respond at all

Practical Tips

Use All 3 Tools for a Comprehensive Analysis

The more critical the third-party, the more comprehensive your assessment should be.

6 Ways to Mitigate Third Party Financial Risks

1. **Ask questions** during check-ins and business reviews
2. **Establish contingency plans** for critical relationships
3. **Diversify** vendors providing critical goods and services
4. **Negotiate** shorter-term contracts
5. **Eliminate advances** & tie payment terms to deliverables
6. **Monitor** through risk intelligence solutions

How Our Client Mitigated Financial Risk

1. **Identified the vendor as critical**
2. **Spotted red flags** during business reviews and general conversation
3. **Business Owner communicated** with the Vendor Management Office
4. **Diversified** vendors
5. **Negotiated** low-commitment contract

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6 Tips for an Effective Assessment

1. Limit assessments to key third parties.
2. Ensure a subject matter expert performs the assessment.
3. Always ask for audit reports.
4. Use questionnaires when you can't get financials.
5. Integrate risk intelligence data into your analysis.
6. When red flags come up, have a conversation with the third party.

Q&A

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