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Auditing Third Party Risk Management

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EMPOWERING INTERNAL AUDITORS : EMBRACING THE 4IR

Auditing Third Party Risk Management

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1. Why an organisation use third party services?
2. What are the risks of engaging third party services?
3. How to manage the third party risks?
4. How to perform third party audit engagement?

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Why an organisation use third party services?

1

Who are the third parties?

Joint ventures

Vendors/ suppliers

Manufacturing service providers

Business channels

Logistic providers

IT providers

Legal service provider

Business associates

Advertising and promotional partners

Maintenance service providers

Reasons for using third party services

Efficiency

Expertise and experience

Unparalled supports

Geographic reach, scale, and flexibility

What are the risks of engaging third party services?

2

Risks of engaging third party services

Financial risks
- Cost overruns.
- Failure to collect penalties.
- Misuse of funds.

Legal/ compliance risks
- Corruption.
- Conflict of interest.
- Civil and environmental damages.
- Fraud.
- Breach of regulation or law.

Strategic risks
- Reputational damage.
- Loss of intellectual property.
- Creating competitors.
- Political uncertainty.
- Catastrophe.

Human resource risks
- Inadequate training.
- Lack of personnel.
- Lack of ownership.

Technology risks
- Lack of business continuity and disaster recovery.
- Failure to test compensating controls.
- Breach of security, privacy, and confidentiality of information, especially sensitive or non public information and data

Operational risks
- Breach of physical security.
- Fourth parties risks.
- Compromised quality.
- Missing records.
- Disruption in customer services
- Breakdown in supply chain
- Inadequate, unreliable, or untimely risk assessments.

Third Party Reliance Risk –

Dell' outsourced call centers

Dell is a well-known brand of personal computers which are sold directly to end-users. Its revenue increased from 6.2 millions USD in 1985 to 62 millions USD in 2009. Dell was the number one market share in USA and globally for a long time. In order to **better serve a large number of customers and cut down costs**, Dell outsourced the call centers in India.

Although Dell has set up many call centers in India and the market share of Dell has continued to grow, **customer satisfaction had dropped**. In 2003, Dell stopped using a technical support center in Bangalore, India to handle calls from U.S. customers due to many complaints, mainly is poor customer service quality.

Root causes?

The review showed that the outsourced call center failure was due to **improper planning** for the short term and long term plan which resulted in the following issues:

- Lack of technical knowledge – **insufficient training** to catch up with the new technology.
- Difficulty in **getting good talent** in India - Dell had lost 30 percent of manager because other companies are willing to pay more than Dell.
- **Different cultures** may lead to misunderstanding or miscommunication and the result is the customers are not satisfy about the service.

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Source: https://www.cnblogs.com/lei1016cn/archive/2011/03/09/1977851.html

Third Party Reliance Risk –
State of Indiana vs IBM Scandal

Indiana State signed a 10-year $1.6billion outsourcing contract with IBM to modernise and privatize its welfare system to reduce costs and fix decades of federal regulation violations. The new system lets citizen apply for welfare benefits online, in person or via telephone, and it implemented process changes designed to speed up and standardize eligibility determinations. But the initiative drew criticism for high error rates and slow processing of eligibility request. The federal government recommended to halt rolling out the system and revert to the manual process to determine eligibility for state assistance programs….

IBM claimed that it has been committed to the success of the project and blamed the economic recession and Midwest floods which triggered a 33% increase in social service applications since the modernization began which made the transition difficult. Indiana and IBM ended up suing each other….

Root causes?

The failure could have been avoided with some common sense. The court found that the real issues **– self interest, conflicting agendas, lack of competence, and unacknowledged risks** – were largely ignored until it was too late.

Source: https://www.govtech.com/education/102471609.html and https://www.thebalance.com/lessons-from-indianas-failed-outsourcing-deal-2553038

Third Party Reliance Risk – DBS vs IBM Scandal

There was instability in a communication link in the storage system which was connected to DBS mainframe. IBM as the contractor was **fixing the errors using an improper method** to keep the system functioning. It caused **system outage** on DBS mainframe on 10 August 2010. After the incident, MAS announced that DBS is required to apply a multiplier of 1.2 times to its risk-weighted assets for operational risk, meaning DBS is required to set aside approximately SGD 230 million in regulatory capital.

Root causes?

After the investigation, it is known that DBS ***lacks in planning and monitoring of the 3rd party reliance risk*** as stipulated in SG GC, resulting in the ***weakness in risk management and internal control*** for risk arising from the work of sub-contractors.

Source: www.dbs.com

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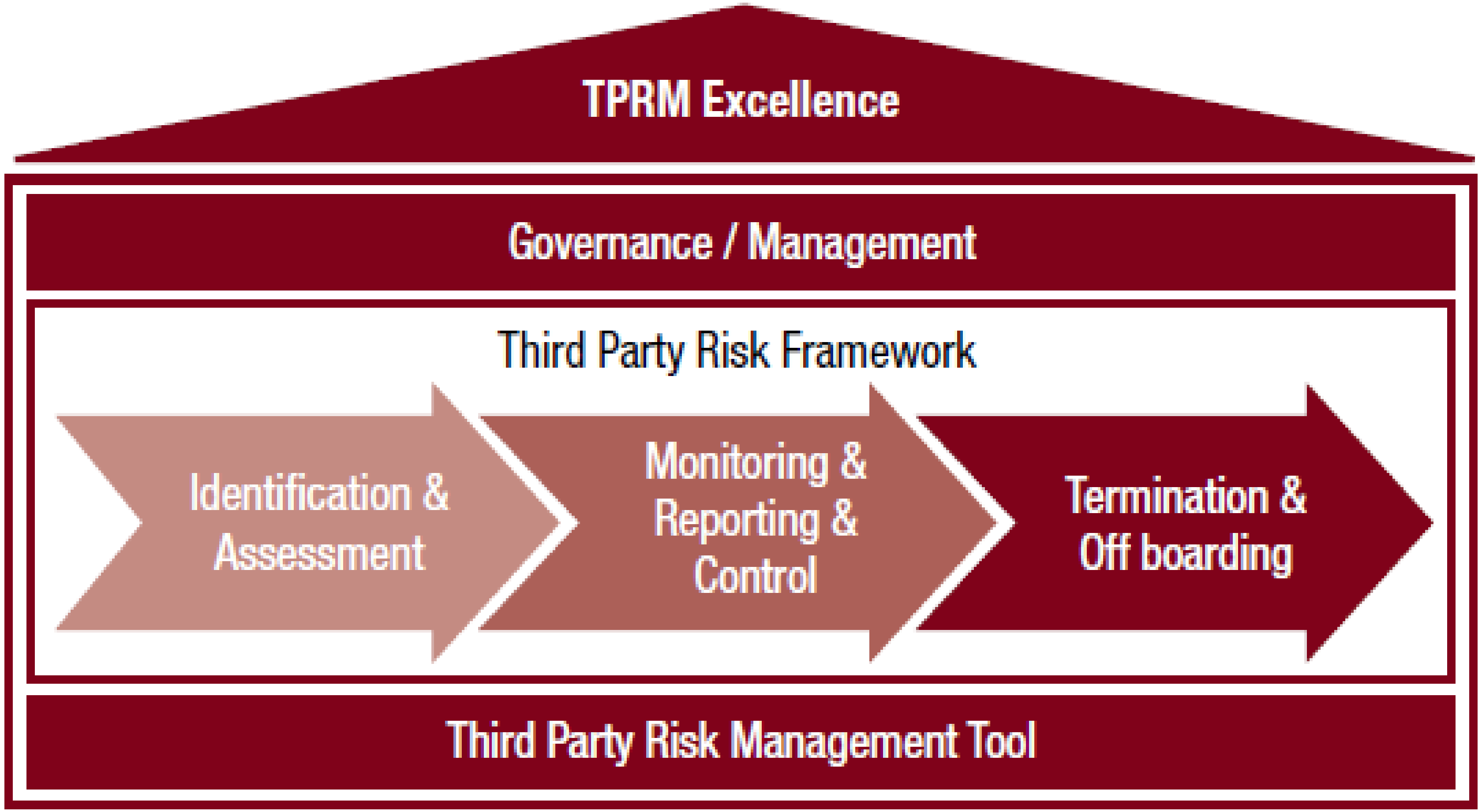
How to manage the third party risks?

3

Third Party Risk Management (TPRM)



Third-party risk management provides a function for **management** **to identify, evaluate, monitor and manage the risks** associated with third parties and contracts.

TPRM Processes

Identification and Assessment		Monitoring, Reporting, and Control		Termination/ Off Boarding
Planning/ Sourcing	Due Diligence	Contracting	Monitoring and issue resolution	Termination

• Identify the potential product/ service to be outsourced.
• Develop plan to manage the relationship, starting with **identifying** the **inherent risk profile**.
	Prior to contracting, review of potential third parties to:
	• Select a Third Party with the **appropriate qualifications**.
	• Understand the **Third Party's controls to mitigate the inherent risks** posed by the relationship.
		• Define expectations and responsibilities of the Third Party.
		• Include clauses to **enforce** the contract terms and conditions, **limit** the organization's **liability**, and **mitigate disputes** on performance.
			• Include **risk and performance management** in the contract execution and ongoing monitoring.
			• **Identify, remediate, and escalate issues** to authorised personnel.
			• Maintain contingency plans to **enable transition** in-house or to another Third Party.
				• Terminate contract when
				  • a contract expires.
				  • contract default.
				  • changes to the organization's or Third Party's business strategy.
				• To execute against written contingency plans to mitigate risks during termination.

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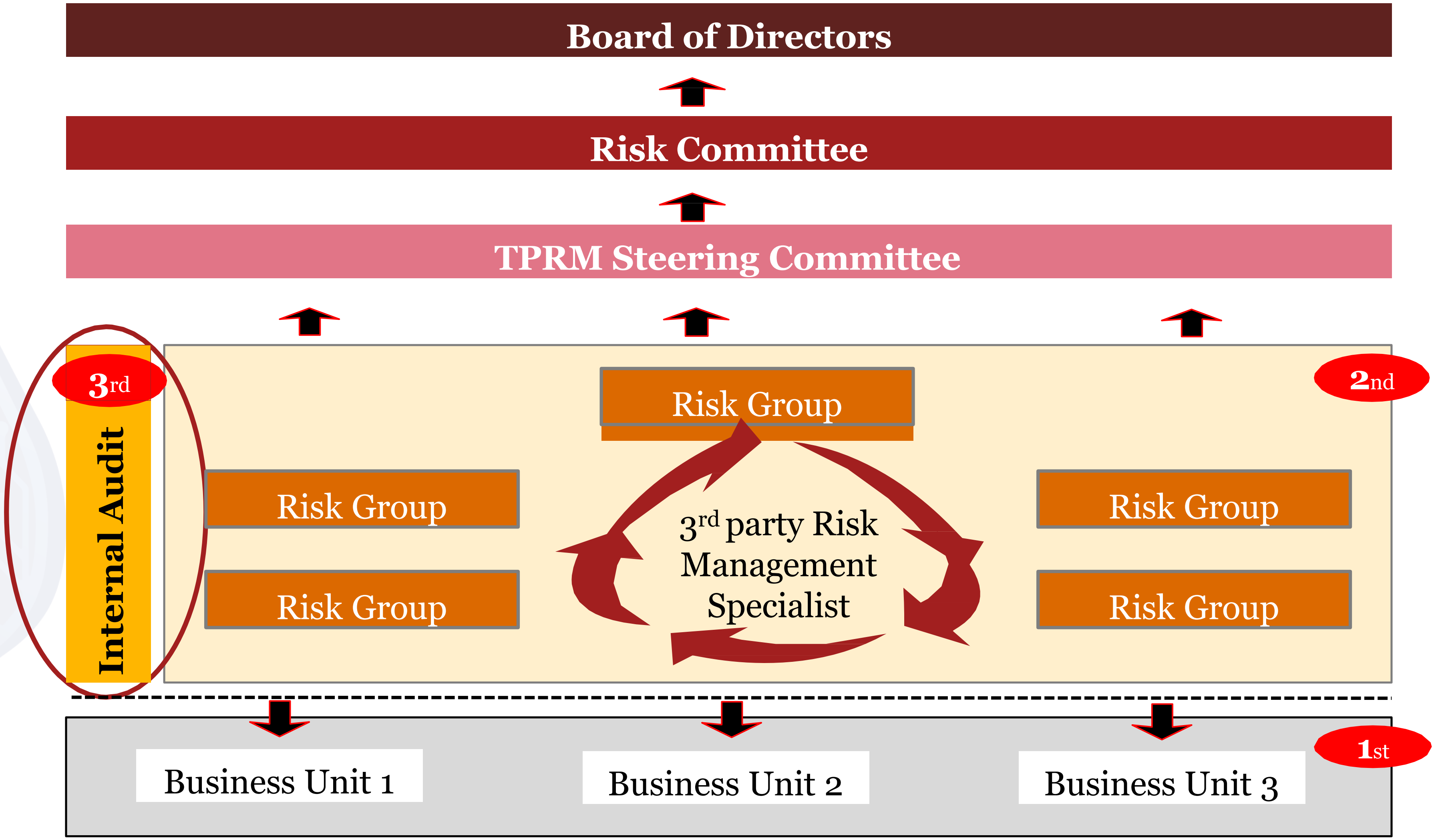
TPRM ⇔ Three Lines of Defence



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Internal Auditor's Roles in TPRM

1 Planning/ Sourcing

- **Reliability** of the **information** used in the business case.
- Whether **governance and approval processes** were executed **according to** the organization's third-party risk management **policies and procedures**.
- Whether estimates of the **third party's failure** to meet expectations and resulting impact are included in the **business case**.
- The sensitivity of **cost-benefit analysis to assumptions.**
- Any **KPIs** or other data included in the business case that should be included **in the monitoring process.**

2 Due Diligence

To ensure proper **due diligence and risk assessments** have been conducted **at the beginning** of a relationship with a third party **and regularly** commensurate with the third party's **risk exposure level.**

3 Contracting

To advocate for **the right to audit** as well as being granted unfettered **access to the necessary data and information** from third parties when conducting audit activities.

4 Monitoring and Issue Resolution

- May be **difficult to scope the assessment of effectiveness** of an organization's **third-party monitoring** processes.
- When, fourth party is engaged, IA needs to:
  - Examine fourth party information to ensure **integration into the due diligence process**. or
  - Evaluate the **contract and contracting process** to ensure proper review by management.
  - **Work with third party for issue resolution**, if necessary.

5 Termination

- To involve as **advisor** or validate the **appropriateness of conditions** (such as retrieval or destruction of data)
- To confirm **thorough descriptions of termination conditions** in each contract as part of routine audit procedures.

Internal Auditor may be involved in each TPRM phase

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Internal Auditor's Roles in TPRM – cont'd

The role of internal audit is to perform two distinct services: (i) independently evaluate the effectiveness of the program and (ii) ensure the program is doing the "right" things

Be independent and examine whether the deployed TPRM Program controls are designed properly and are operating as designed, as related to activities occurring at the third party locations.

Consider recent regulatory guidance and industry recommended practices when reviewing the TPRM Program to ensure the organization is focusing on the "right" things.

Not be influenced by what TPRM or Subject Matter Specialists may have completed.

Focus on the more significant relationships from an inherent and residual risk perspective based on the second line of defence's risk assessments.

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Common Challenges with TPRM Audits

Auditing **perceived high risk vendors** without auditing the **program or process.**

Focusing on Third Party **spend** instead of **risk.**

Not applying the same level of scrutiny as regulators.

Not thinking broadly enough (incomplete TPRM program).

Focusing on **completion of activities by the 1st and 2nd line** instead of the **quality of the activities and the skills and capabilities** of the individuals managing the risk

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How to perform third party audit engagement?

4

Performing the Third Party Audit Engagement

1. Gather Information to understand the Area or Process Under Review
2. Conduct a preliminary risk assessment of the area or process under Review
3. Form Engagement Objectives
4. Establish engagement scope - potential scope limitations
5. Allocate resources
6. Document the plan – on site audit

Report the engagement results

Key Success Factors of Auditing Third Party

1. Full coverage of all the **pillars of TPRM**.
2. **Adequate qualified staffing**.
3. A well-documented **third party policy and program**.
4. **Full support** from **the board and senior management** team.
5. Forward looking **third party program**
6. **Responsive to new business regulations**.
7. **Invest in education and industry resources**.
8. **Revisit your program** to keep it updated.
9. **Use industry enforcement actions** to apply good practices and/ or lesson learned.


ANY
QUESTIONS?

Thank you

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