Decide with Confidence

Government Best Practices for Mitigating Contractor Risk

A simple yet powerful roadmap enables agencies to reduce risk and increase oversight of contractors

WHITE PAPER

Decide with Confidence

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Section I: Executive Summary

Shortly after taking office, President Barack Obama announced his intention to "dramatically reform the way we do business on contracts" by improving accountability and transparency in government spending and performance.[1] Although federal acquisition regulations have long required agencies to determine contractor responsibility, the Obama Administration is establishing new standards for stronger, more effective contractor risk management by requiring agencies to mitigate risks related to contractor financial and operational stability and prevent fraud, waste and abuse.

In recent years, a set of best practices has emerged among public and private sector organizations that have successfully minimized contractor risk. In particular, the most successful organizations:

- Establish standardized processes for mitigating contractor risk;
- Validate potential contractors with rigorous due-diligence during the pre-award phase;
- Monitor contractor risk during the post-award phase;
- Adopt a portfolio view that assesses and manages the collective risk of contractors across the entire organization;
- Use automated reporting tools to strengthen management, transparency and oversight.

The renewed emphasis on transparency and oversight represents an unprecedented opportunity and challenge. It offers agencies a chance to demonstrate their ability to perform important public services efficiently and effectively. But doing this will require agencies to implement rigorous processes and tools for mitigating contractor risks. Those that have already done so are seeing positive results.

Transparent government, like e-government, is becoming a routine way of doing business.

The trend toward vigorous contractor risk management, which is occurring at all levels of government, will continue to grow as public leaders look for ways to cut costs while improving operations and services. "This is just the beginning of a new way of doing business here in Washington," President

[1] "Remarks by the President on Procurement," March 4, 2009.

Obama said when unveiling his reform agenda, "because the American people have every right to expect and to demand a government that is more efficient, more accountable, and more responsible in keeping the public's trust."[2]

Section II: The Challenge Facing Government

The recent push for greater transparency in the federal government's contracting process actually began with Congress, which in 2006 approved the bi-partisan Federal Financial Accountability & Transparency Act (FFATA). This legislation led to the creation of USAspending.gov, a government website that describes who receives government funds and how those funds are spent. Similarly, state governments are also improving visibility into government spending and performance through programs such as Open Book Texas and the Missouri Accountability Portal. Transparent government, like e-government, is becoming a routine way of doing business.

The Obama Administration outlined its new requirements for transparency and oversight, including contractor risk management, in its guidance for implementing the $787-billion American Recovery and Reinvestment Act. In a February 18th memo, Peter R. Orszag, Director of the Office of Management and Budget (OMB), directed agencies to put in place processes to ensure that the funds are used for authorized purposes while mitigating fraud, waste, error, and abuse.[3] Agencies also must provide clear, accurate and timely reports describing stimulus expenditures and their benefits to the public.

Achieving these goals will not be easy. Although the concept of contractor risk management is not new, agencies are still working to strengthen the rigor of their "contractor responsibility determinations" required by the Federal Acquisition Regulation (FAR). Among the challenges they face are legacy database issues, incomplete or outdated contractor information, and disconnected (or "siloed") information systems that inhibit visibility. Many agencies are just starting to use available applications and tools that could

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[2] Ibid.

[3] "Memorandum for the Heads of Departments and Agencies," February 18, 2009, p.2.

help automate and standardize the due diligence process. Similar problems can hamper the monitoring of contractors after contract award as well.

The economic downturn presents another major obstacle to effective contractor risk management. Many agencies have shortages in their acquisition workforces and lack sufficient resources to meet the administration's new oversight goals. At the same time, the recession has increased the likelihood of business failure, business fraud, and other high-risk activities that can undermine program performance. In short, agencies are being asked to implement more rigorous standards for mitigating contractor risk at a time when resources are strained and business risks are increasing.

Many public sector leaders, while acknowledging these challenges, view the new mandates as invigorating for their organizations. As Debra Sonderman, Chief Procurement Officer at the Department of Interior, recently told *Government Executive* magazine,[4] "In some ways, the Recovery Act has raised the level of importance of having the acquisition professional involved in strategic decision-making.… For an acquisition person to see that the work they're doing can be a direct part of strengthening our country's economy is a very big deal." Craig Hooks, acting Chief Acquisition Officer at the Environmental Protection Agency (EPA), adds, "Our focus is on ensuring oversight, accountability and unprecedented transparency of the funds and how they are spent."[5] Consequently, acquisition executives are scrambling to put in place the right processes and resources to rigorously monitor their programs on a continuing basis.

Section III: Best Practices for Contractor Risk Management

Thus, how can agencies meet their oversight responsibilities? The most cost-effective solutions for strengthening accountability and combating waste focus on identifying and preventing problems before they occur. Interior Inspector General Earl Devaney, who chairs the Recovery Act Transparency

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[4] Elizabeth Newell and Robert Brodsky, "Big Spenders: Government's top procurement officials scramble to award unprecedented amounts of contract funds," *Government Executive* (June 15, 2009), www.govexec.com/features/0609-15/0609-15s4.htm.
[5] Ibid.

and Accountability Board, estimates that organizations often lose as much as 7 percent of spending to fraud. That would amount to more than $55 billion of the $787 billion appropriated for the Recovery Act. "We have to get in on the front end and try to prevent waste, fraud and abuse before it happens," he said."[6]

Organizations often lose as much as 7 percent of spending to fraud. That would amount to more the $55 billion of the $787 billion appropriated for the Recovery Act.

Earl Devaney,
Chairman
Recovery Act Transparency and Accountability Board

Effective contractor risk management does just that: it prevents and reduces supply chain disruption, fraud and other related problems by attacking them on the front end. Contractor risk management validates that potential government contractors are viable, legitimate businesses. It also confirms that they have the financial capability and organizational resources to provide the required services. At the same time, it makes sure that contractors are not engaged in questionable ethical or legal activities. Successful contractor risk management programs save staff time, resources and money by reducing significantly the number of problems related to contractor non-performance or fraud. It also enables the smooth performance of government programs and functions that otherwise might be disrupted by critical failures on government contracts.

In our experience helping public and private sector organizations, we are seeing an emerging set of best practices for mitigating contractor risk throughout the acquisition lifecycle. The best practices for contractor risk management are:

1. **Establish a standardized decision framework for mitigating contractor risk.** Having a standardized approach across the agency enables consistency, professionalism and rigor that strengthen decision-making and contractor oversight. As agencies create these processes, they also should select and incorporate the most appropriate software applications and tools for automating

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[6] "Transcript: Earl Devaney," *Wall Street Journal*, March 8, 2009. Devaney's assertion that as much as 7 percent of funding is lost to fraud may seem high, but we have found instances where the percentage is even larger. The GAO, for example, estimated that during the first 18 months following Hurricane Katrina, the government made about 16 percent—or $1 billion—in improper and potentially fraudulent payments to applicants who used invalid information to apply for disaster assistance. "Actions to Implement Select Provisions Post-Katrina Emergency Management Reform Act," p. 28.

this oversight function. Agencies that standardize the oversight process not only reduce contractor risk but also make their decisions less vulnerable to protests and other events that prevent the timely award of new contracts and task orders.

2. **Validate potential contractors with rigorous due diligence during the pre-award phase.** Agencies should evaluate the capabilities of both prime contractors and their subcontractors. As stated in the Federal Acquisition Regulation (FAR), prior to awarding a contract, an agency should verify that prospective contractors are "responsible" and capable businesses by verifying that the contractors:

    - Have adequate financial resources—or can obtain adequate resources—to perform the contract;
    - Can comply with the proposed delivery or performance schedule;
    - Have a satisfactory performance record;
    - Have a satisfactory record of integrity and business ethics;
    - Have the necessary organization, experience, accounting and operational controls, and technical skills—or the ability to obtain them, such as through subcontractors;
    - Have the necessary production, construction and technical equipment and facilities;
    - Are qualified and eligible to receive an award under applicable laws and regulations, such as those relating to small business and other set-aside contracts, Buy American provisions, etc.[7]

As part of the validation process, agencies also should understand the extent to which a particular prime contractor is dependent on subcontractors to deliver critical products and services. For example, a high-risk subcontractor that provides important products or

[7] Federal Acquisition Regulation, Subpart 9.1: Responsible Prospective Contractors, 9.104-1, General Standards.

services could create hazards for an otherwise low-risk prime contractor.

3. **Monitor contractor risk during the post-award phase.** After awarding contracts, agencies should continue monitoring the financial and organizational health of their prime contractors and subcontractors. A company's leadership, operations, profitability, and ability to perform can change rapidly, particularly in the current economic climate. In fact, Dun & Bradstreet's experience working with government contractor data has shown that, on average, 20 percent of an agency's database will undergo significant changes during a fiscal year.

   And change can increase potential risks. For example, a contractor with a satisfactory performance record to date could experience financial or operational difficulties that negatively impact that contractor's ability to perform on the contract. Thus, agencies must not only track a contractor's performance on a particular project, but also monitor the health of the contractor and subcontractors to assure continued performance throughout the contract.

   In addition, post-award due diligence should include real-time alerts as well as periodic checks on the financial and operational stability of contractors whose contracts exceed specified dollar thresholds. These thresholds can be determined by agency leaders when they establish a standardized decision framework for mitigating risk. With fully automated contractor risk management processes in place, agencies can monitor contractors continuously and, when alerted to potential risks, take proactive steps to avoid problems before they occur.

4. **Adopt a portfolio view that assesses and manages the collective risk of contractors across the entire organization.** When monitoring contractor risk, an agency must examine the combined risk of its entire portfolio of contractors and

subcontractors across the agency. For example, a contractor might be experiencing financial difficulties that would cause relatively moderate concern if that contractor worked on only one agency contract. But if that contractor supported numerous agency programs, then its risk level would be much higher, because the contractor's financial difficulties could cause major problems throughout the agency.

Similarly, an agency might have the resources to address moderate to severe risks among, say, 3-5 percent of its contractors; but a higher percentage of contractors at these risk levels would be unmanageable. Thus, the problem isn't with any one contractor but with the cumulative impact of those representing moderate to severe risks.

Finally, adopting a portfolio view also means evaluating the risks associated with a contractor's corporate parent or related corporate entities. For example, the financial troubles of the corporate parent could impact a contractor's ability to obtain financing, skilled staff or other resources necessary to perform on a project.

5. **Use automated reporting tools to strengthen management, transparency and oversight.** Agencies must be able to provide detailed information about how funds are spent to demonstrate that they are complying with the goals and policies established by Congress, the White House, or agency leaders. The Recovery Act, for example, requires agencies to report on which contractors, subcontractors and other entities have received funds. The White House also is tracking the geographic locations where stimulus money is spent, while also ensuring that agencies are meeting various statutory requirements to buy American products and award contracts to small and disadvantaged businesses.

   Reporting tools with dashboards to display spending, compliance, progress toward completion and other measures are an integral part of contractor risk management, because they provide agency leaders with visibility into their entire portfolio of contractors.

Section IV: Effective Contractor Risk Management Using Dun & Bradstreet

Most government officials are familiar with the D-U-N-S® Number, which is Dun & Bradstreet's unique means of identifying and tracking an entity globally throughout all phases of its life.[8] Dun & Bradstreet has leveraged the D-U-N-S Number – and the databases that support it to create powerful tools for mitigating contractor risk. These tools can present contractor data and risk analyses in dashboards and other displays that enable decision makers to quickly assess and manage contractor risks.

For many agencies, a good place to start is with a Contractor Checklist that standardizes and guides due-diligence during both pre- and post-contract award phases. If the collected information raises "red flags" regarding a contractor, agencies can take steps to address potential risks. Some organizations create more-detailed decision trees to guide these steps. The Contractor Checklist is a simple yet valuable tool—if the contractor information is reliable. Consequently, many organizations use D&B's patented DUNSRight® process to ensure that their information is timely, accurate and complete. For example, all of the information in the sample checklists below (Diagram 1) can be obtained using the DUNSRight process.

[8] Because the D-U-N-S® Number is an industry standard, universally recognized and used throughout the globe, the U.S. government in 1994 adopted the D-U-N-S Number as a unique identifier for organizations doing business with the government. Consequently, federal contractors must now provide a D-U-N-S Number when registering in the CCR system, so that agencies can use the number to track contractors in their acquisitions systems.

Diagram 1: Contractor Checklist

Use of standardized checklist can help procurement professionals across the agency conform to FAR and Recovery Act guidelines as well as mitigate risk

Pre-Award Contractor Checklist	Post-Award Contractor Checklist
OPERATIONS	**OPERATIONS**
Confirmation of Legal Business Name and Address	Address/Facilities Change
Verification of Business Existence ("Proof of Right' Evidence)	Merger or Acquisition
Validation of Years in Existence/Under Current Management Control	Management Turnover
Confirmation of Capacity to Perform	Confirmation of Capacity to Perform
- Annual Revenue	- Annual Revenue
- Number of Employees	- Number of Employees
- Size and Location of Facilities	- Size and Location of Facilities
Active Operating Status	
Executive or Management Team Background Check	Executive or Management Team Background Check
SIC or NAICS Relevancy Check	
FINANCIALS	**FINANCIALS**
Low Risk Scores	Negative Trend in Risk Scores
Secure Financing	Financing Challenges
Positive Payment Trends	Negative Payment Trends
Payment History Compared to Industry	Negative Payment History Compared to Industry
Business Solvency Ratios	Weakening Business Solvency Ratios
Efficiency Ratios	Weakening Efficiency Ratios
Profitability Ratios	Weakening Profitability Ratios
ETHICS	**ETHICS**
Satisfactory Performance Record	Unsatisfactory Performance Record
Absence of Suspensions/Debarments	Presence of Suspensions/Debarments
Absence of Suits, Liens or Judgments	Presence of Suits, Liens or Judgments
Absence of Evidence of Criminal or Fraud Activity	Evidence of Criminal or Fraud Activity

Many organizations also bolster their Contractor Checklists with rigorous financial risk assessments using Dun & Bradstreet's Predictive Indicators. The Predictive Indicators, which are a key component of the DUNSRight process, use statistical analysis to provide risk information about contractors and their future behavior, such as their likelihood of failure or ability to make payments. Many agencies use the Predictive Indicators to perform due diligence during pre-award selection and post-award monitoring of contractors.

Agencies, of course, do not need sophisticated scoring models to identify *obvious* high-risk and low-risk businesses. But the potential risks among the vast majority of contractors are neither obvious nor constant. When conducting contractor due diligence, agencies typically uncover a combination of data points that are contradictory and difficult to evaluate. For example, a contractor might have a solid payment history but a large number of pending judgments or liens. It may have an outstanding performance record but very few customers. Agency decision makers may wonder: What do these "red flags" mean for this particular contractor in this particular industry—and for our particular program? Dun & Bradstreet's predictive scores are based on both a wealth of historical data and finely-tuned algorithms that can place the red flags in their proper context and accurately assess the likely risk based on a multitude of variables.

The Predictive Indicators include a variety of scores that can be used individually or in combination with one another to measure financial and operational risks. The different scores are:

- **Financial Stress Score (FSS)** — predicts the likelihood of an entity ceasing business without paying all of its creditors within the next 12 months;
- **Supplier Evaluation Risk (SER)** — predicts the likelihood that a supplier will fail within the next 12 months;
- **Commercial Credit Score (CCS)** — predicts the likelihood that a business will pay its bills in a severely delinquent manner within the next 12 months.

At the most simplistic level, agencies can adapt the scores to a "stoplight" approach for evaluating contractors (See Diagram 2). That is, agencies can determine in advance which scores merit approval (Green Light), rejection (Red Light), or further investigation (Yellow Light) for a responsibility determination.

Diagram 2: Agencies Streamline Decision Making Using Contractor Risk Scorecards

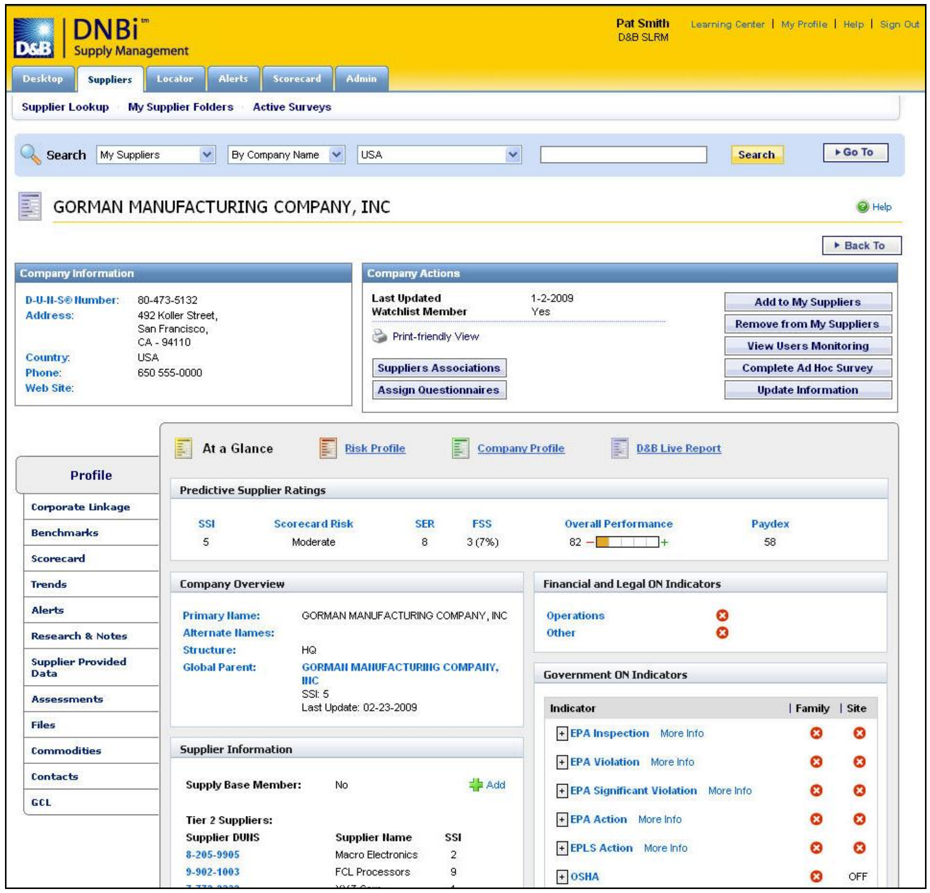
	Green = Approve (SER Score 1-3) (FSS Percentile 80-100)	• Low Risk Scores • Low Exposure
	Yellow = Further Review (SER Score 4-6) (FSS Percentile 31-79)	• Medium Risk Scores • Higher Exposure • Review Criteria
	Red = Reject (SER Score 7-9) (FSS Percentile 1-30)	• High Risk Scores • High Exposure

How might an agency use this approach? The agency would quickly approve a potential contractor whose low-risk score placed it in the Green-Light category. Likewise, the agency would quickly reject a small business that was placed in the Red-Light category because it had no record of income in the previous fiscal year, no record of a business license in its state of operation, and two IRS liens totaling $175,000. On the other hand, a large consulting firm that has filed for Chapter 11 bankruptcy but is continuing to work for both commercial and government customers—and has a substantial pipeline of work—might yield a Yellow-Light rating. In this case, the agency might decide to continue investigating or monitoring this company.

The Predictive Indicators can also generate web-enabled dashboards that provide detailed snapshots of each contractor's risk profile (see Diagram 3). This allows agencies to "drill down" and view specific areas of potential risk. Used together, the risk dashboards and scorecards can significantly streamline the due-diligence process in both the pre- and post-award phases of a contract.

Diagram 3: Web-Enabled Due Diligence – Pre and Post Award

A web-enabled dashboard can provide a snapshot of a contractor's financial and operational stability.



A D&B customer with 23,000 global suppliers was able to increase the percentage of suppliers monitored from 5% to 100%.

Once the information and processes are in place for creating the score cards and dashboards, agencies can also create automated alerts to inform them of significant changes within their contractor portfolios, such as notifying them when a contractor moves into the agency's high-risk (or Red-Light) category. For example, a Dun & Bradstreet customer with 23,000 global suppliers was able to increase the percentage of suppliers it monitors for such issues as financial stability, quality and delivery, debarment, suits, and environmental and safety compliance from 5 percent to 100 percent. In one instance, the organization was able to predict with a six-month lead time the bankruptcy of a key supplier.

As shown in Diagram 4, Dun & Bradstreet's alerts can provide significant advance notice of pending trouble with a supplier, enabling agencies to take steps to mitigate the potential risk. Agencies usually can anticipate problems with large companies, such as General Motors or BearingPoint, whose financial troubles dominate headlines. But supplier alerts are extremely valuable for tracking small to mid-size companies whose problems might not become apparent until it's too late to take corrective action.

Diagram 4: Supplier Alerts

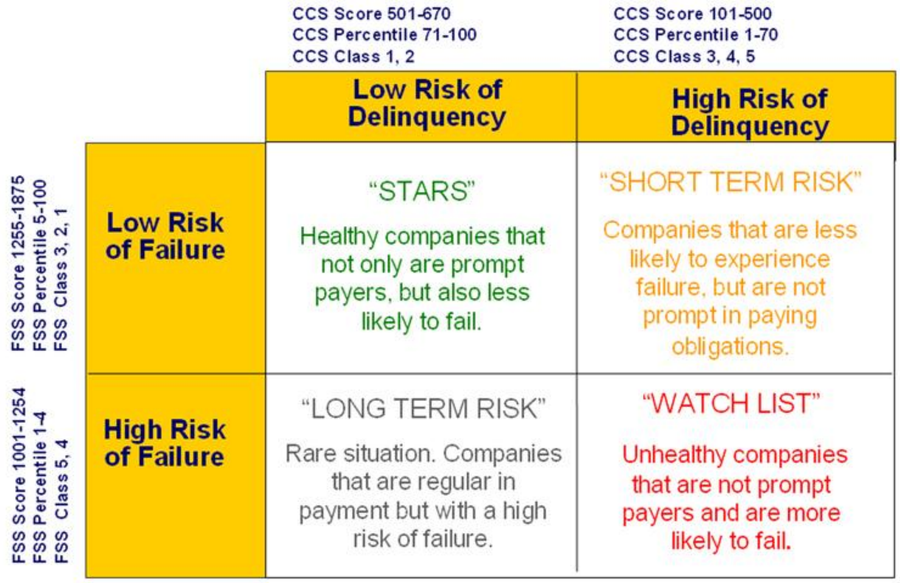
D&B insight allows companies to take action before suppliers declare bankruptcy.

Company Name	Bankruptcy Filed	Date of D&B Alert	Days in Advance
Peanut Corp. of America	2/13/2009	1/30/2009	14
Spectrum Brands, Inc.	2/3/2009	1/1/2009	33
Thinkpath, Inc.	3/8/2008	1/2/2008	66
Primus Telecommunications Group, Inc.	3/16/2009	1/3/2009	72
Lexington Precision Corp.	4/1/2008	1/1/2008	91
Process Development Corp.	11/18/2008	8/1/2008	109
Brown Corporation of Waverly, Inc.	5/19/2008	1/2/2008	138
Heckethorn Manufacturing Co., Inc.	5/19/2008	1/1/2008	139
General Growth Properties	4/16/2009	11/22/2008	145
Milacron Inc.	3/10/2009	10/6/2008	155
Sterling Mining Comp.	3/3/2009	9/2/2008	182
Engineered Sinterings And Plastics, Inc.	7/1/2008	1/1/2008	182

Dun & Bradstreet also provides consulting services as well as the tools for mitigating contractor risk. In engagements ranging from small government offices to major departments, D&B consultants have helped agencies determine their risk tolerance, establish a risk strategy and adapt best practices for contractor risk management to meet their unique mission challenges. This includes developing standardized processes and then selecting and implementing the right tools to provide rigorous due diligence during pre- and post-contract award. And, of course, D&B also works with agencies to customize their reporting tools so they can respond effectively to new federal requirements for improved accountability and oversight.

Diagram 5: Managing Portfolio Risk

An agency should monitor the level and type of risk that contractors pose to the agency.



Agencies also can merge their contractor data with Dun & Bradstreet's business intelligence and implement automated online solutions that are customized for their specific contractor risk management needs (see Diagram 6). The various risk measures and analyses are presented in dashboards that allow decision makers to view, sort, and analyze contractor and spending data in a wide range of categories, such as industry, geography, spending amounts, and diversity classification. Agency officials can quickly generate reports that reveal which contractors have the highest dependency on the agency for their revenue, which contractors are at risk, whether these are critical contractors, and where the agency's risk is located (by industry, spend category, geographic region, and business unit).

Diagram 6: Automated Reporting

This online reporting tool shows the risks associated with an agency's contractors, both individually and in aggregate.

"The court also recognizes that D&B is a recognized leader in the field of evaluating the financial strength of companies, and is known as an independent reporting service that is frequently used by government contracting officials."

United States Court of Federal Claims, in 2001 ruling upholding DOD in contract dispute

Agencies supported by Dun & Bradstreet's information and services have found that their procurement decisions can successfully withstand contractor protests and challenges. For example, after the Department of Defense used Dun & Bradstreet's analysis to help select providers of move management services, a judge for the U.S. Court of Federal Claims rejected the protest of a failed bidder, noting "the court also recognizes that D&B is a recognized leader in the field of evaluating the financial strength of companies, and is known as an independent reporting service that is frequently used by government contracting officials."[9]

For many years, contractor risk management was more art than science. Agencies would make risk assessments by combining anecdotal and quantitative information—if available—in an ad-hoc manner. But today, government organizations can take a scientific approach, one that is not only continuous and proactive, but also holistic and encompassing. Predictive analytics, which are learned over time, provide accurate insight and information, as well as industry specific support and analysis.

[9] United States Court of Federal Claims, No. 00-599C (filed January 3, 2001), p. 20.

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“Scientific, data-driven approaches to supply risk management require information and analysis about suppliers from multiple sources.”

Jim Lawton
Vice President
Supply Management Solutions
Dun & Bradstreet

“The most critical information about your supply base comes from outside the four walls of your organization,” said Jim Lawton, Vice President and General Manager of Dun & Bradstreet’s Supply Management Solutions. “Scientific, data-driven approaches to supply risk management require information and analysis about suppliers from multiple sources.”

Section V: Conclusion

The demand for increased transparency and accountability can place a great strain on agency staff and resources. Moreover, the rapid expansion of government spending and programs magnifies oversight challenges, particularly those related to mitigating contractor risks. Ultimately, government efforts to improve transparency and oversight will lead to greater operational efficiencies and lower costs by reducing waste, fraud and abuse. The challenge facing agency leaders is finding the most cost-effective path to achieving these goals, in both letter and spirit.

The best practices for contractor risk management provide such a roadmap. Agencies that have embraced these practices have significantly improved their ability to mitigate contractor risks. By taking advantage of new tools and technologies, agencies have been able to automate oversight processes and become more proactive in managing contractors, identifying risks, and preventing problems before they occur. And this leads to a government that, in President Obama’s words, “is more efficient, more accountable, and more responsible in keeping the public's trust.”

For more information on D&B’s Contractor Risk Management approach, call 1.800.424.2495 or email government@dnb.com