

SUPPLIER SELECTION – DUE DILIGENCE

Introduction

We were recently reading an Aircraft Accident Report Ref: J10/2/7132. It refers to a tragic accident in South Africa when a Piper aircraft crashed, with loss of life, near Rand Airport. It should be noted that the purpose of the investigation was not to establish legal liability. Certain aspects of the report have direct relevance to supplier selection and the process of due diligence. There is reference that the financial officer of the charter service client requested quotations from several operators for the intended weekly flights. She received three quotations and accepted the lowest-priced offer.

It is worth contemplating what process would be in place in many organisations. Some would have gone through a pre-qualification process, with potential suppliers completing a questionnaire. Some would have a Supplier Appraisal (or similar named document) and would ask the supplier to complete that. Some would make no enquiries whatsoever and the documents previously completed may not be checked. Most projects and contracts have risk attached to them, including the risk of selecting the wrong supplier. This article is designed to assist professional buyers to consider their existing process.

Management Structure

The report states that the aircraft operator is a small operation. This may not be a weakness but it must be understood. The company founder and Chief Executive Officer holds the position of Responsible Person: Aircraft and is also a line pilot. Other management position include the General Manager (non-flying) who also acts on Responsible Person: Flight operations, the Chief Pilot and the Aviation Safety Officer/Senior Pilot (who perished in the accident). It is vital that the management structure of suppliers be understood to ensure clear accountability for contract performance and decision making. Organograms can be made to look exceptionally structured but do they reflect reality?

Safety Management

This would be a vital consideration in selecting an airline. The report states that interviews conducted with the aircraft operator's management and staff indicated that there was no formal process of regular Flight operations meetings or briefings in place. Nor were there any formal safety management, safety promotion or safety occurrence reporting programs in existence. Ticks in boxes on a questionnaire may not reveal these inadequacies. It would require meticulous inspection on-site. Such an activity is part of due diligence but requires a resource to carry it out. There are some industrial sectors where safety management is a statutory requirement. These include nuclear engineering, transportation, chemicals, agriculture, food and drugs.

Regulatory Compliance

The report states that inspection of the company records indicated considerable deficiencies existed with response to requirements laid down with the approved company operations manual. These deficiencies were categorised into five areas, personnel record keeping, aircraft documentation, operational documentation, compliance with flight and duty time limitations requirements, and flight training. In some sectors of industry there are regulatory requirements with which suppliers must comply. But are they? Either the buyer's company personnel does the checking or they employ a competent third party, expert in their field. It is self evident that checking should be conducted and that a failure to do so attracts certain risks.

History of previous violations

It states that the evidence suggests that the deviations from standard operating procedures, noted for the accident flight (flying with an overloaded aircraft: not weighing passengers and baggage nor completing required mass and balance documentation) were not isolated incidents. Is this relevant to due diligence more generally? Indeed it is! The track record of a supplier is a crucial matter. Some matters can be checked. Prosecution for violations is an obvious area, as is the forfeit of bonds. The simplest way is to ask the supplier, leading questions. The UK Government "Court Service" website search engine is worth a visit.

Organisational Culture

The report draws an interesting parallel between an "unsafe act", a decision made by the pilot-in-command and the professional organisational and in some cases the national culture in which the individual operates. This raises very important questions for supplier due diligence work. The organisational culture is difficult to feel in a brief visit, but talking to a cross-section of personnel is essential. Experience in these matters will help to gain immediate impressions into indicators such as, cutting corners, aggression, unprofessional practices, staff disquiet, quality consciousness, etc.

Operational Documentation

This is the next subject dealt with in the report, which reads, "several aspects of operational practice were found to be inconsistent with requirements laid down within the approved company operations manual". More condemning is the observation that during interviews conducted with the staff it was apparent that their familiarity with the requirements laid down in some very pertinent sections of the manual was generally poor. But it gets worse! In many cases, operations manuals are compiled by aviation consultants who produce a generic manual, which fulfils regulatory requirements, but may not be suitable for all aspects of their client's operations. This is the problem of 'ticks in boxes'. The presence of a manual does not mean compliance with it. Spot checks can be done, but it is only effective on a visit.

Aircraft Maintenance Organisation

The report examines the inspection regime carried out on the company providing maintenance oversight for the aircraft operator. The air worthiness inspector also carried out the renewal inspection. A checklist was used. Under the section about the Store there are notes made to a point in the checklist and then no more comments or marks were made. The last question that was marked is: Does the store hold shelf life products? The answer provided was “yes”, but the next question: How are standards maintained with respect to those products? Areas are not answered and from there onwards none of the questions on that page.

Contract Law - Misrepresentation

If supplier appraisal questionnaires are issued and information is supplied it may be incorrect. Relief may be claimed if there was inducement to enter into a contract by a misleading statement. The tragic aircraft crash previously referred to raises some matters that, depending on the nature of the contract, would typically be considered. With misrepresentation it must be unambiguous and material, and must have been relied upon. The general rule is that no relief will be given for a misrepresentation unless it is a statement of existing fact. There may be no remedy for mere puffs, statements of opinion and a representation as the future.

Important areas for due diligence

It is quite common for annual accounts to be requested. When they are provided they should be analysed for such things as turnover, profitability, cash at the bank, level of inventory, work-in-progress, borrowings, cash flow, debtors and creditors, and so on. The information should be up to date (not accounts that are more than 18 months out of date), and therefore interim accounts are often required. A banker's reference may be required. A Parent Company Guarantee may be sought.

The ability of a supplier to procure goods and services, and manage the supply chain is important. Curiously, it is an area not often probed. Contracts are often late, and this may be a contributory reason.

To complete examples, let us consider sub-contractors of a supplier. How are they managed and how does the buyer know their competence levels? Quite often we don't know and therefore performance is in the lap of the gods.

Conclusions

Due Diligence in the selection of a supplier is vital. Continuing surveillance is also vital. The performance of suppliers makes or breaks our own performance. Procurement should activate appropriate due diligence studies.

Brian Farrington Ltd accept assignments to conduct these studies and are supported by their alliance partners who can provide additional financial, legal and other specialist due diligence services.