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A Short Guide to Procurement Risk

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① Procurement and Risk – The Big Picture

PROCUREMENT'S PLACE IN THE BUSINESS ... AND THE NEED TO GET IT RIGHT

Every business enterprise uses suppliers in one form or another. It is inherent in the business model. One enlightened CEO described her company's business in this way: 'we buy, we transform and we sell.' She added: '... and we need to be equally good at all of that if our business is to be as successful as possible.' In other cases it might be more accurate to say 'this is what we do and what we sell to our customers, and we use external sources (of whatever) to make it possible to do that.' In the public sector, the equation could be expressed as 'we buy, we add value and we deliver.' The point is that no company or public sector organisation is an island. Resources are needed at one end of the business just as customers are required at the other.

Traditional procurement is no stranger to risk management, witness any good company's approach to contract terms and conditions and supply planning. But things move on. Public

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and private sector organisations have outsourced activities previously conducted in-house; what were domestic supply chains now span the globe in search of low cost sources; and communications technologies have dramatically increased the possibility and appetite for rapid, constant change ... whilst also rendering a company's activities more transparent and open to public scrutiny.

Despite this, most companies are so focused on managing the people and assets employed in the business and on satisfying their customers that they fail realise what is going on behind them in their supply markets. And it is not all good news:

- Vulnerabilities in physical supply chains are poorly understood and managed. This has been identified as one of four emerging risk issues likely to impact in the years to come.¹ The recent capture by Somali pirates of a cargo ship serves as a stark lesson that this is no theoretical forecast and that the 'unimaginable' does happen. Increasing supplier bankruptcies coming in the train of the economic crisis only add to supply chain woes.
- High growth in the Chinese economy in 2007–08 drove huge price increases in commodity raw materials along with additional concerns about shortages of supplies for Western economies. Freak weather conditions in Brazil and India caused wholesale prices of sugar to hit a near 28-year high, up 80 per cent in 2009 alone. An expected knock-on effect will be a global shortage of sweeteners as big importers of sugar switch into them as a substitute.

1 *World Economic Forum Report*, January 2008, 'Global risks 2008'.

- Although its supplier had breached a contract, a customer company had to accept a court ruling in favour of the supplier because the buyer had not exercised the contract's termination clause in a timely manner.²
- The value of procurement fraud in the UK increased by 347 per cent during 2008.³
- And truth continues to be stranger than fiction. Workers at a recently bankrupted French company supplying the car industry threatened to blow it up if their redundancy compensation claims were not satisfied. 'The gas bottles are in the factory. Everything is ready to blow it up,' said a union representative.⁴

Another company knew exactly what it was doing in its supply market but was caught for manipulating supplier behaviour.⁵ The computer chip manufacturer was found guilty of engaging in illegal practices, one being to make payments to suppliers to halt or delay the launch of products containing competitors' components.

The view that supply chain vulnerability is an ongoing concern is confirmed by the fact that Aon's 2009 Global Risk Management Survey⁶ includes supply chain failure in its Top Ten most pressing risks around the world. Interestingly at least half of the risks in the Top Ten can be directly related to procurement activity, and hence would fall within the remit of

2 *Supply Management*, 30 April 2009, 'Use it or lose it'.

3 *Supply Management*, 11 June 2009, 'The pressure is on'.

4 *The Daily Telegraph*, 14 July 2009. (The claim was settled without the need for detonation!).

5 *Supply Management*, 28 May 2009.

6 insight.aon.com 'The Definitive Report on Risk, 2009'.

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Procurement Risk Management (PRM).⁷ One consequence of this is that procurement risk has emerged as a comprehensive topic in its own right rather than being a facet of specific but fragmented procurement tasks. The benefit of this ‘promotion’ up management’s agenda is the requirement for more clarity about what is ‘procurement risk’ and greater awareness that risks can lurk in areas where traditionally they have not been sought.

However, a comprehensive commercially aware approach to procurement is not the norm. In its absence, organisations experience one or more of the harming events listed in Box 1 and will under-perform, maybe not survive, as a consequence. The impact of supply chain disruption on business performance has seldom been better described than in Hendricks and Singhal’s comprehensive, and sobering, study of its effect on long-term shareholder value. To quote from their concluding summary:⁸

The evidence presented in this report makes a compelling case that ignoring the risk of supply chain disruptions can have serious negative economic consequences. Based on a sample of more than 800 supply chain disruption announcements, the evidence indicates that firms that suffer supply chain disruptions experience 33 to 40 per cent lower stock returns relative to their benchmarks, 13.5 per cent increase in share price volatility, 107 per cent drop in operating income, 7 per cent lower sales growth, and 11 per cent increase in costs. By any yardstick these are very significant

7 In addition to supply chain failure the risks are: business interruption; commodity price risk; damage to reputation, and cash flow/liquidity risk.

8 Hendricks, K. and Singhal, V. 2005. *The Effect of Supply Chain Disruptions on Long-term Shareholder Value*.

economic losses. More importantly, firms do not quickly recover from these losses. The evidence indicates that firms continue to operate for at least two years at a lower performance level after experiencing disruptions. Given the significant economic losses, firms cannot afford such disruptions even if they occur infrequently.

BOX 1

WHAT ARE THE RISKS OF NO PROCUREMENT RISK MANAGEMENT?

- Profit, budgets, and cash flow are all hurt:
 - substantial reductions in shareholder value occur
 - need to maintain a far higher than necessary level of risk capital
- Customers kept waiting or turned down.
- Helplessness in dealing with supplier price increases.
- Output prices forced up with loss of competitiveness.
- Poor supplier performance or, worse, allocation or loss of supply.
- Fragmentation and loss of procurement negotiating leverage.
- Legally unsound contracts heavily biased in suppliers' favour.
- Unproductive use of human resources.
- Insufficient 'internal challenge' of specifications and decision-making.
- Decision-makers prey to the tactics of salespeople.
- Political embarrassment or damage to company image and reputation.

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- Vulnerable to internal and external fraud.
- Exploited and manipulated by monopolies, cartels and hostile contractors.
- Supplier innovations passed to competitors.
- Beaten to the market by competitors with new products or services.
- Too quick or too late to market with own new offerings.
- Damage to brand and company reputation by unethical behaviour or incompetence.
- Organisation is penalised for non-compliance with regulatory requirements.
- Organisation's activities become subject of public scrutiny and investigation.

The ultimate goal of risk management is to protect and enhance what the enterprise is primarily there to do. In the private sector the aim is profitable survival. The public sector equivalent is to deliver maximum service and organisational effectiveness within the constraints of the resources provided to do it. This includes money. But is the risk-catching net being cast wide enough? Focusing on risks external to the company tells only half the story. What is less well known is that risk exposures also exist inside the company and can be just as damaging.

Whilst excellent articles are written about PRM, the balance of content trends in the direction of risk evaluation and mitigation rather than something which is arguably even more important, namely identifying risks at the outset. As one Chief Procurement Officer (CPO) observed: 'we are good at

reacting to issues when they arise but not good at populating our risk register in the first place.'

'PLAYING WITH FIRE': THE ELEMENTS OF PROCUREMENT RISK MANAGEMENT

Procurement Risk exists for an organisation 'when supply market behaviour, and the organisation's dealings with suppliers, create outcomes which harm company reputation, capability, operational integrity and financial viability.'

The key word in this definition is 'harm'. This requires judgement, criteria, and maybe calculation, to decide if an event is potentially harmless or harmful. It is also necessary to distinguish between what is 'at risk' (that is, 'exposed') and the possible event that does the damage. For example, the company's ability to meet delivery commitments is exposed to the possibility of supply disruption or if a key supplier becomes bankrupt. Recessions mean that suppliers shut down production capacity to save overhead costs, which eventually lead to shortages when the upturn comes. Suppliers use price increases to ration supplies. Thus, financial performance and the ability to meet budgets is now exposed to the significant price increases that suppliers can impose when it is a seller's market.

In examining what was at risk, one public sector organisation addressed the question 'in what way could our work or existence be harmed if untamed risks escaped to do us damage?' Four main exposures were identified:

1. reputation;
2. operational continuity;

3. financial viability;
4. being a target for litigation.

The need to be clear about 'what is exposed' arises because, without it, it is difficult to work out what it is worth to reduce or prevent a risk from occurring. For example, the cost of a lost day of production is easily calculated. A possible disruptive event might be a strike at the haulage company that has the job of delivering production raw materials. The strike could feasibly last for five days. The contingency plan may be to hold a five-day stock of materials as insurance against the possibility of the strike. The cost of this plan can be compared with the cost of five days of lost production. If the contingency plan costs less than the impact of the strike then it makes sense to action the plan. An apparently cheaper option would be to hold the supplier responsible for the costs of non-delivery and seek to recover these afterwards. But this is reactive, will involve a lot of work to get the money back, and still leave a dissatisfied ultimate customer whose order has not been fulfilled. These indirect costs must be added into the total evaluation.

Another reason for taking pains to define exposures is that it helps to identify potential disruptive events. The usual approach is to say 'here is a supply chain ... what could go wrong with it, and what would be the cost of the harm done?' This convergent approach will identify possible events, but not as many as will be revealed by divergent thinking. The latter starts with an exposure ... e.g. reputation ... and then imagines all the supply-related things that could happen to tarnish it. 'Our reputation is exposed to the actions of others ... how many things can we think of that will damage our reputation if they happen?'

The combination of an exposure and an event is an ‘impact’. If disruptive events happen and the company is exposed as previously mentioned, then the impacts are:

- tarnished reputation;
- interrupted day-to-day operations;
- spiralling costs;
- being sued.

Events actually have to happen to be harmful. But how likely are they to occur? Sophisticated mathematics can be used to estimate probability, but for most purposes ‘high, medium or low’ will often suffice, although the case for slightly more precision is made in Chapter 7. These terms can be quantified as follows:

- *high* means ‘event will occur in most circumstances and one event can be expected each year.’
- *medium* means ‘will probably occur at least once every five years.’
- *low* means ‘not expected to occur in normal circumstances and less than once in every five years.’

Finally, what can be done to mitigate an undesirable impact caused by a high- or medium- probability event occurring? A mitigating action will reduce, eliminate, or compensate for the harm done and, in general, will involve either direct or indemnity actions. Direct action will reduce or eliminate

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the 'at risk' situation (e.g. by laying down some contingency stockholding), whereas indemnity actions are designed to 'let harm happen' but to provide compensation in the event (e.g. taking out insurance to cover business continuity).

The different elements of being 'At Risk' can be connected as follows:

Being 'At Risk' = Impact × Probability × No Mitigation

where Impact = Exposure × Event

Just as fire is extinguished when either fuel, *or* oxygen, *or* temperature, is removed from a conflagration, so removing or reducing one or more elements in the above equation prevents being 'at risk'. However, effective PRM does include accepting some risks, with these situations being monitored to avoid being caught out if things change. Other situations can be left 'at risk' but contingency plans are ready should risks materialise. And where real trouble lurks, urgent action is required followed by regular audit.

TARGETING PRM IN THE RISK LANDSCAPE

Many definitions of risk management exist but are often too vague to be useful, such as 'risk is the probability of incurring loss or misfortune'. Most definitions focus only on the possibility of a disruptive event, such as a break in the supply chain, but what also matters is the failure to take advantage of an opportunity from which the organisation could benefit. This is recognised in the UK's Office of Government Commerce

(OGC) approach which defines risk as ‘uncertainty of outcome, whether positive opportunity or negative impact.’⁹

As stated earlier in this chapter, procurement risk exists for an organisation ‘when supply market behaviour, and the organisation’s dealings with suppliers, create outcomes which harm company reputation, capability, operational integrity and financial viability.’ This guide then defines Procurement Risk Management (PRM) as ‘the name given to the measures taken ... including changes to behaviours, procedures and controls ... which remove procurement risks or reduce them to what is considered to be an acceptable level.’

There are a number of pre-requisites for risk identification to be effective. Two important ones are the already-discussed need to link an event to an exposure to quantify its impact, and the need for unbridled creativity in imagining potentially disruptive events in the first place. A comprehensive search for ‘at risk’ situations surveys five different landscapes where risks may lurk:

- external dependencies (e.g. supply chain robustness, supplier viability);
- market conditions and behaviours (e.g. competitive or not; supply availability);
- procurement process;
- management controls;

⁹ www.ogc.gov.uk ‘Achieving Excellence, Guide 4: Risk and Value Management’.

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- ability and agility to handle unexpected events.

External Dependencies concerns the reliance on supply companies; their values and viability; performance, and the durability of supply chains. *Market Conditions and Behaviours* concerns the competitiveness or otherwise of supply markets; supply availability; price trends and the regulatory context. *Procurement Process* covers the way different people work together in all decision-making and behaviours which affect the customer's dealings with suppliers. *Management Controls* refers to the proper use of authority in the company; the framework whereby it is delegated and the principles expected to be employed. In effect this is the DNA of the procurement process. And the *Ability to Handle the Unexpected* means just what it says.

No one of the five risk landscapes is more important than the others. Figure 1.1 shows the 'Risk Catcher' which keeps the total risk management panorama in view, and the search process comprehensive. Importantly, this integrated approach encourages different risk specialists to come out of their silos of operation. For example, 'management controls' is usually the province of the company's Chief Internal Auditor; 'handling the unexpected' the concern of the Risk Director; and 'external dependencies' the focus of the CPO. These three do not often meet, but some joint risk catching gives them the reason to do so. The result of a shared risk analysis will be superior to the sum of its parts, with the bonus that non-procurement people have their eyes opened to the risks and opportunities presented by supply markets.

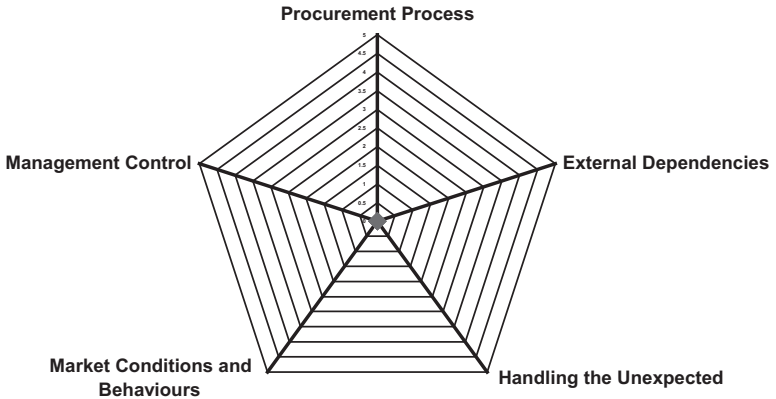


Figure 1.1 The ‘Risk Catcher’

In the next five chapters, each of these risk landscapes is considered in more detail. We start with the subjects most often written about, namely, a company’s dependence on external supply chains and its exposure to hostile market conditions. Then follow two less fashionable topics ... ‘less fashionable’ only because little is written about them. This may reflect the fact that they are not truly understood or that they are not held to be important. The opposite is true. Procurement Process and Management Controls are highly potent sources of risk, and all the more so if believed to be not relevant. The final topic deals with the occurrence of unexpected events and how some people and companies are better than others at handling them.

Each chapter provides examples of potential risks and what the remedies look like. Whilst this is useful, there is the danger that only the symptoms of problems will be fixed rather than their root causes. Hence, once the more concerning ‘at risk’ situations have been dealt with, it is important to make

further changes which create a working climate and culture where PRM is a fact of day-to-day life rather than a specific task only revisited when the risk register needs updating. Thus the next five chapters also present the underlying principles of risk prevention appropriate to each risk landscape. These ensure a proactive approach to PRM where risks are less likely to materialise and do harm, as distinct from reactive PRM where disruptions are 'allowed' but where harm is prevented by the safety net of contingency plans or by being quick on one's feet.

When done well, a high-performance risk-aware procurement process provides the bonus of competitive advantage, with the ability to capitalise, rather than suffer, from the occurrence of unexpected events. This short guide explains how to do it. But before delving further, it is necessary to take stock of where an organisation currently stands vis-à-vis PRM best practice. Box 2 offers the means of a first self-assessment.

BOX 2

PROCUREMENT RISK MANAGEMENT: SELF-ASSESSMENT OF PRM PREPAREDNESS

Assess your company's PRM-preparedness by testing against the following criteria (1 = low, 5 = high)

Procurement Process

1. Procurement is non-existent as an identifiable defined process in the company.
2. Procurement behaviour is streetwise and deal-oriented but with little structure or functional influence.

Internal IT systems offer visibility of the supply chain.

3. Procurement activity is procedures-oriented and focused on internal customer service, albeit responsive to need.

Requisitions (timing and quantity) are driven by the company's daily operations' planning system.

IT systems have basic supplier information feeds and basic risk models are in place.

4. Procurement activity relies heavily on leverage and muscle-power.

Requirements are defined by the planning system and/or by commercially sensible considerations.

Decision-making is supported by analytical tools and an effective information system infrastructure.

IT systems provide real-time feeds on the status of goods within the supply chain.

5. Procurement is a core cross-company process integrated into the company strategy and designed to maximise sustained shareholder value. Comprehensive costed risk models are maintained and frequently updated.

External Dependencies

1. Orders and contracts are 'casual' or ad hoc and are usually on suppliers' terms and conditions.

Purchases are often made by 'non-purchasing people' with few, if any, records of transactions made.

2. All suppliers are treated the same way, although some get more attention than others. Activity is 'today' orientated.

There is a legal basis for contracts placed.

3. Supply chains are generally understood and selective contracting strategies are used.

Few, if any, contract loopholes exist and supplier performance is monitored.

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4. Key supply chains are understood in detail. Supplier relationships vary from 'arms-length' to 'close collaboration'.

Vulnerability Analyses have been completed and contingency plans are in place.

5. An active and productive Supplier Relationship Management programme is in place. PRM is comprehensive.

Management Controls

1. Nothing is codified ... all decisions and actions are 'intuitive' and/or require top level approval.

2. Basic business standards, principles and policies are defined.

A framework for Authority Delegation may exist but is most likely to be out of date.

3. As 2 but the policies and authorities are regularly reviewed and updated.

Specific controls are defined which relate to the procurement process.

Functional authorities are clearly specified (in terms of purpose and clarity).

4. As 3, plus authorities are substantial and reflect an empowered, skilful culture.

Procurement emphasis is on acquiring best total return on acquisition costs.

5. As 4, plus procurement policies are all-embracing (i.e. they apply to all company personnel).

Market Conditions and Behaviours

1. The customer company (i.e. yours) generally feels helpless and is glad to get what they can.

2. The customer company is vulnerable to supplier sales tactics.

Deals are the supplier's standard offering, but may be cosmetically enhanced to please the buyer.

3. Market distortions are understood and effectively counteracted.
 Fundamental drivers of supply costs are understood and trends are monitored.
4. Measures are in place which reflect awareness of the possibility of fraud and unprincipled supplier behaviour.
5. For key requirements, strategies are in place to influence supply markets and to elicit desired market responses (e.g. Reverse Marketing).

Handling the Unexpected

1. We know that the unexpected can happen but we hope that it won't.
2. 'Logical' contingency plans are in place but tend to be specific to a contract.
3. Comprehensive PRM is in place.
 By definition this includes strategies and contingency plans for all identified critical suppliers in terms of profit impact.
4. The company organisation exhibits the characteristics of High-Performing Teams and is agile yet goal-oriented when addressing unforeseen events.
 IT systems monitor numerous aspects of the supply chain over and above materials' flow. Examples are supplier solvency and natural catastrophe alerts relevant to the supply chain.
5. Not possible as no one can predict everything that might happen! The gap between '4' and '5' represents the space for the random event to materialise.

FURTHER QUESTIONS FOR URGENT ATTENTION

- How many of the undesirable events shown previously in Box 1 do we experience and what are we doing about them?
- Do we know which are our key supply chains and what potential events they are vulnerable to?
- Have we specifically evaluated how our corporate strategies and business plan can be helped or harmed by supply market events?
- Do we have a systematic process for identifying and evaluating procurement risks?
- Is our procurement process segmented into silos or does it lean more towards being a continuum of parallel operational and commercial activity?