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Procurement Executive Insight
Study Results Analysis
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Complimentary Research

Integrated Risk Management: A Playbook for Procurement

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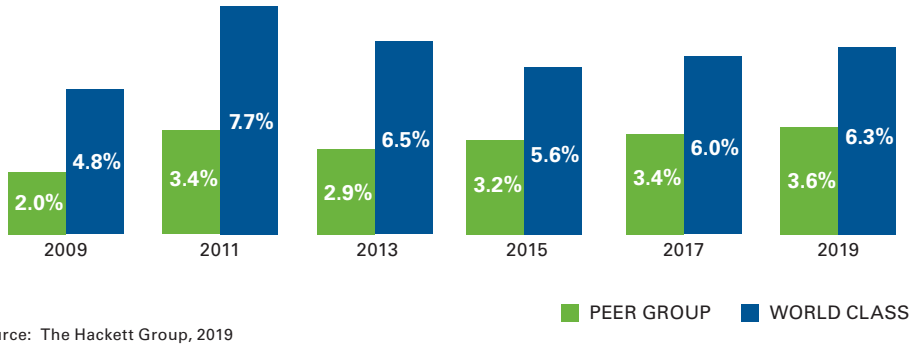
Executive Summary

Risk is moving up on the agenda of corporate leadership due to its impact on the bottom line, market valuation and shareholder value. As modern supply chains grow more complex, the historical predominance of reactive risk management is no longer sustainable. The Hackett Group expects broad adoption of formalized supply risk management programs by world-class procurement and supply chain organizations in coming years. While global risks have grabbed most of the headlines, even greater risks may lie much closer to home. In fact, many companies face hazards to their supply chain caused by their own focus on cost reduction in recent years. For instance, while conventional practices like outsourcing, use of mega-suppliers, and Lean and just-in-time inventory management have clear business justifications, collectively they have increased risk by obscuring numerous vulnerabilities.

Introduction

World-class companies are taking action to mitigate supply risk, making it a tangible factor in top procurement performance. While these organizations continue to deliver greater spend-cost savings than the peer group in our benchmark and research database, meeting expectations for year-over-year cost savings has become increasingly difficult. As procurement organizations seek new ways to increase cost savings, the inherent risk of those decisions must be balanced carefully against the rewards **(Fig. 1)**.

FIG. 1 Total spend-cost savings as a percent of annual spend, 2009-19



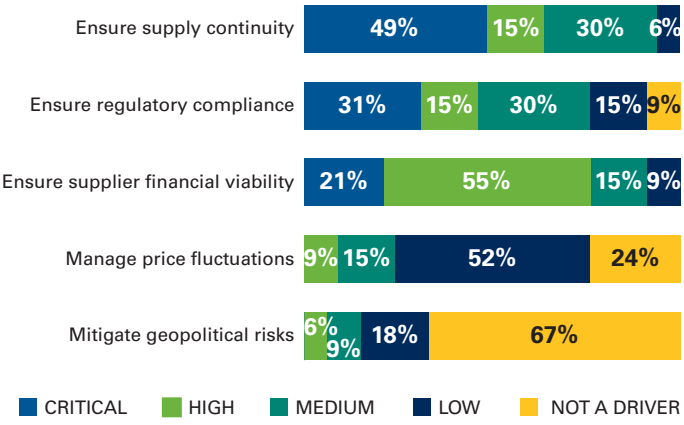
Source: The Hackett Group, 2019

CEOs are generally risk takers when it comes to strategies that promise to increase revenues and profits. They tend to view risk management and compliance as necessary evils whose costs must be minimized. It is up to those who manage supplier risk and compliance to show just how vital this topic is to maintaining the flow of revenue and profits.

Supply risk management systematically and proactively identifies events with the potential to adversely affect the supply chain. This information can be used to avoid such events or at least reduce their frequency and severity by creating a framework that identifies as many relevant risks as possible and establishes backup processes and systems to minimize their impact. Although the benefits of a formalized supply risk management program are well known, creating one requires sufficient resources and a strong executive mandate.

Supply assurance is a fundamental requirement for any business, and the procurement organization is on the front line when it comes to anticipating and mitigating supply risk. According to 48% of companies participating in The Hackett Group's Supply Risk Management Performance Study, the most critical driver for creating a supply risk management program is to ensure supply continuity (i.e., prevent supply bottlenecks, logistics issues, low stocks and unexpected breakdowns) (Fig. 2). Meanwhile, for 31% of respondents, the most critical driver is to ensure regulatory compliance. Other factors such as managing price fluctuations and mitigating geopolitical risk are of less concern.

FIG. 2 Principal drivers of supply risk management programs



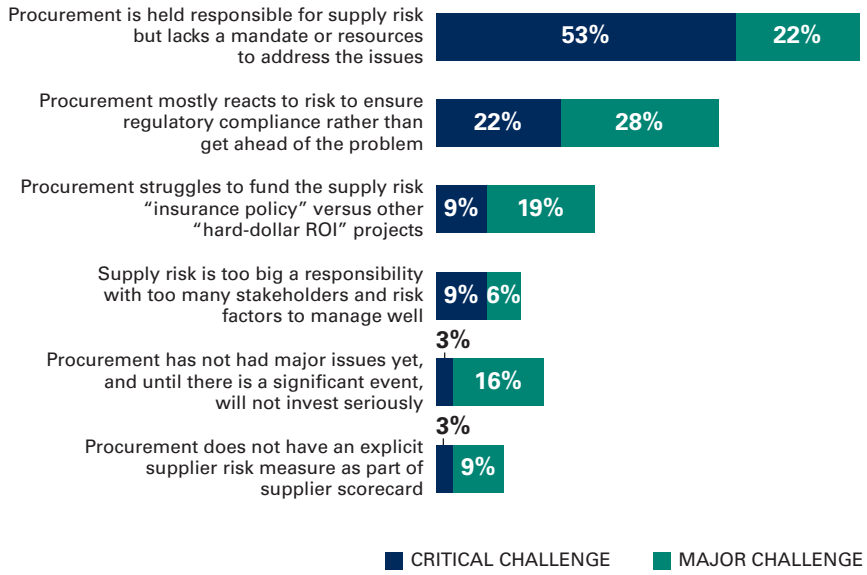
When direct spend is isolated, supply continuity and regulatory compliance are shown to be the main factors prompting companies to invest in supply risk management (unlike indirect spend, where ensuring the financial viability of suppliers is foremost).

That companies are less concerned about price fluctuations is surprising, considering the data also show price volatility to be one of the areas of greatest exposure.

A critical activity in the sourcing management lifecycle is the execution of risk-based due diligence before contracts are executed. Historically, spend was the primary dimension used to classify and rank suppliers, but it is becoming more common to consider multiple characteristics, such as whether suppliers are handling confidential data that is accessed by subcontractors or others in countries that lack adequate intellectual property protections.

Although the benefits of a formalized supply risk management program are well known, companies struggle to set up a program when they lack sufficient resources or a strong executive mandate to do so (Fig. 3). Another hurdle is the tendency to be reactive to supply risk, for example only when it threatens companies' regulatory compliance, as opposed to anticipating and heading off areas of potential exposure.

FIG. 3 Principal challenges to establishing a supply risk management program



Defining Risk Management in Procurement

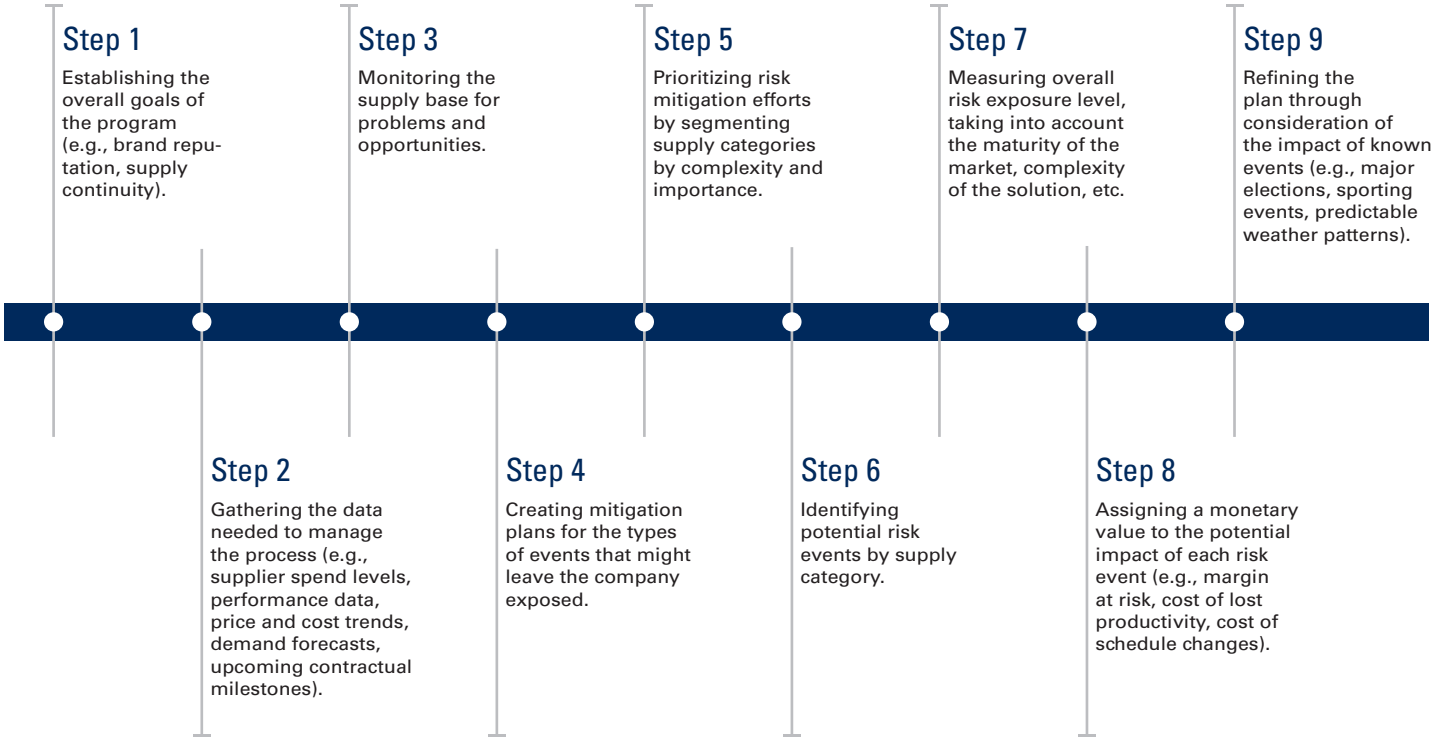
Supply risk management systematically and proactively identifies events that have the potential to adversely affect the supply chain. Companies can use this information to avoid such events or at least reduce their frequency and severity through an effective supply risk framework that identifies as many relevant risks as possible and establishes processes and systems to minimize their impact.

It is important to note that the list of supply chain risks also includes opportunity costs, such as inability to capitalize on market opportunities, including revenue growth strategies and new product launches. Companies can't always manage risk by limiting or eliminating their exposure to it, since this would also reduce or forego opportunity.

From a shareholder-value perspective, risk and opportunity are inseparable. To create value, companies need to know which risks are worth taking, then manage them appropriately.

There are nine principle steps in a supply risk management program (Fig. 4). Even if a company follows all of the steps scrupulously, there is still no assurance that it will be immune to risk. The problem is that each activity represents some level of expense upfront against the possibility of a benefit later on. For every risk that does not ultimately materialize, the mitigation effort is an unnecessary effort and expense. But the opposite is also true: it may not make financial sense to mitigate every known risk. Of course, in practice, the decision is not simply whether to act, but knowing what will work and how much to do.

FIG. 4 Supply risk management program steps



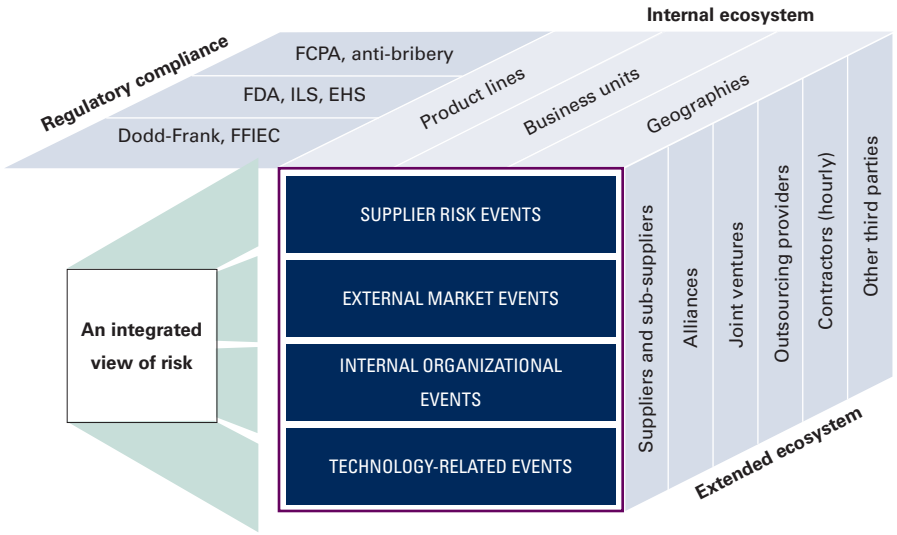
Source: The Hackett Group

Management must assess the probability and likely impact of different hazards and balance this information against the potential cost and results of mitigating actions. The uncertain nature of risks and impacts, combined with the need for continual adjustment of mitigation plans, means that for every risk over a period of time there will be a string of incremental costs from unused mitigations and incremental savings from applied mitigations, combined with the incremental costs of insufficient or excessive mitigation. Only rarely is there ever a perfect match.

Risk exposure can be calculated by multiplying the probability that an event will occur by its potential impact on the company. For example, many risks have a low probability but a high impact. Suppliers, external markets, internal organizations and technology are all potential sources of risk and should be considered together to form an integrated view of risk.

As an integrated view of risk **(Fig. 5)** takes root in more businesses, executives are thinking more broadly about the risks their company faces. Many of the most significant ones are driven by relationships with other entities, such as service providers, demand-side partners (e.g., resellers), alliances and joint ventures.

FIG. 5 An integrated view of risk

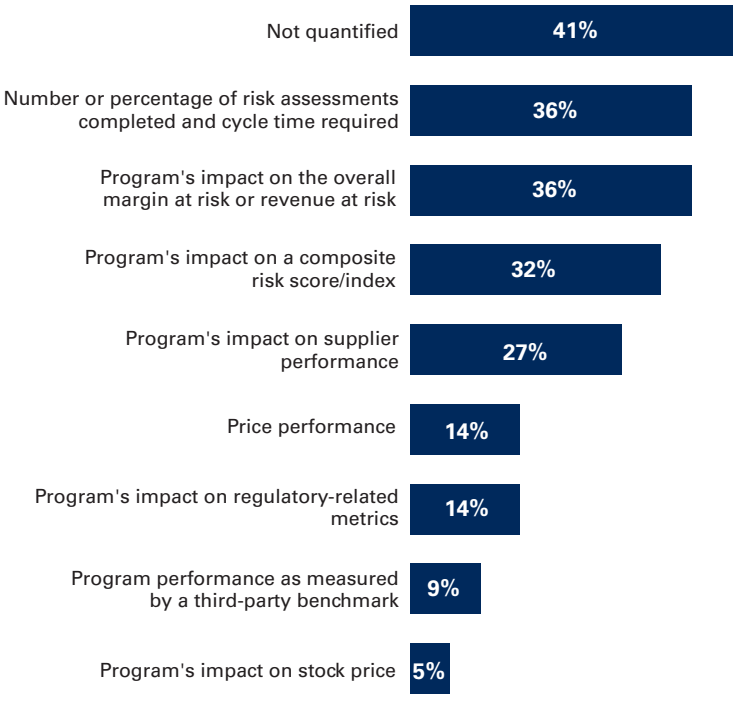


Source: The Hackett Group

Measuring the Value and Performance of a Supply Risk Management Program

Given that many supply risk management programs are relatively immature, basic efficiency metrics are still common (Fig. 6). Asked how they quantify the value of their program, 36% of study respondents look at the number or percentage of supply risk assessments completed and the cycle time required to do so. The metrics are tactical in nature, and used to justify the value of supply risk management by demonstrating that risk assessments are not a bottleneck in the sourcing and delivery process.

FIG. 6 Measurements of value being quantified today



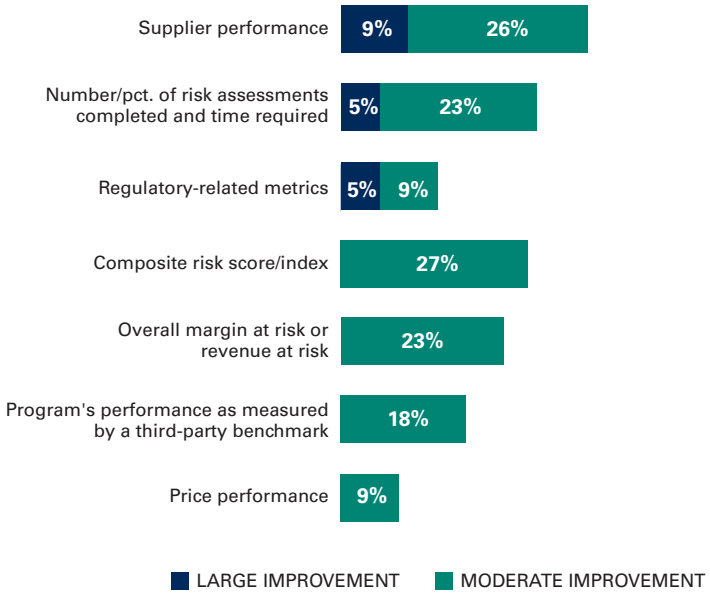
Source: Supplier Management: Managing Relationships and Risk Poll, The Hackett Group, 2018

Sources of integrated risk management cost

- **Assessment/monitoring:** Supplier risk monitoring services, supplier qualification, supplier scorecards/surveys, supplier audits/auditors, contract reviews, product/service inspection.
- **Process:** Scenario planning, risk prioritization, contingency planning, supplier capability studies.
- **External market factors:** Lost profits due to shortages, brand damage, warranty/recall costs, customer complaint management costs.
- **Exception management:** Labor costs for "firefighting" supply-risk failures, scrap/rework costs, emergency supply costs (premium freight, expediting, spot market premium pricing), cost of qualifying new/replacement suppliers, cost of capital from higher inventories.

Other respondents quantify the value of their program by measuring impact on margin or revenue (36%) or by calculating a composite risk score (32%). Then, they implement a narrow set of projects to mitigate risk. These projects are reviewed, approved and managed like any other business project. Once completed, risk exposure or composite risk scores are recalculated to determine whether and by how much risk has been lowered. In this way, the effectiveness of efforts to mitigate supplier risk can be documented empirically. This is a gradual process; most organizations report only moderate improvements in these metrics two years or more into their program **(Fig. 7)**.

FIG. 7 Impact of integrated risk management program on value measurements two years or more after creating the program

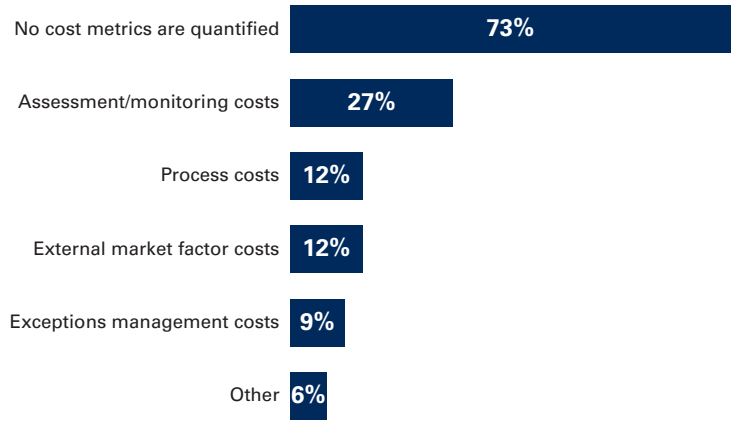


Source: Supplier Management: Managing Relationships and Risk Poll, The Hackett Group, 2018

Increased corporate emphasis on boosting revenue has spurred interest in supply risk management, in that revenue protection represents a significant quantitative benefit. Clear metrics make it easy for teams to demonstrate reduction in risk exposure in the supply base. Regular reports track the risk probability index, cross-product risk exposure and standard deviations for risk.

It must be mentioned that 41% of organizations with a supply risk management program do not measure its impact. Similarly, 73% of respondents do not quantify the costs of supply risk management **(Fig. 8)** *(see sidebar at left)*. This suggests that many such programs are implemented in reaction to a regulation or risk, without the discipline or formality attached to proactively developed programs.

FIG. 8 Cost metrics being tracked today



Understanding the Probability and Impact of Risk Events

Our study analyzed a range of supplier risk events, such as supplier bankruptcy and fraud, supplier quality failures, and rapid degradation in performance. Fortunately, none of these events were categorized as having a catastrophic impact with definite probability. Those with the highest risk exposure (i.e., highest impact and probability) included supplier competitive events (e.g., new mergers or acquisitions; partnerships or industry consolidation), as well as the loss or theft of sensitive data.

We also analyzed other possible occurrences related to supply risk, including events related to external markets, the internal organization and technology.

Supplier risk events*

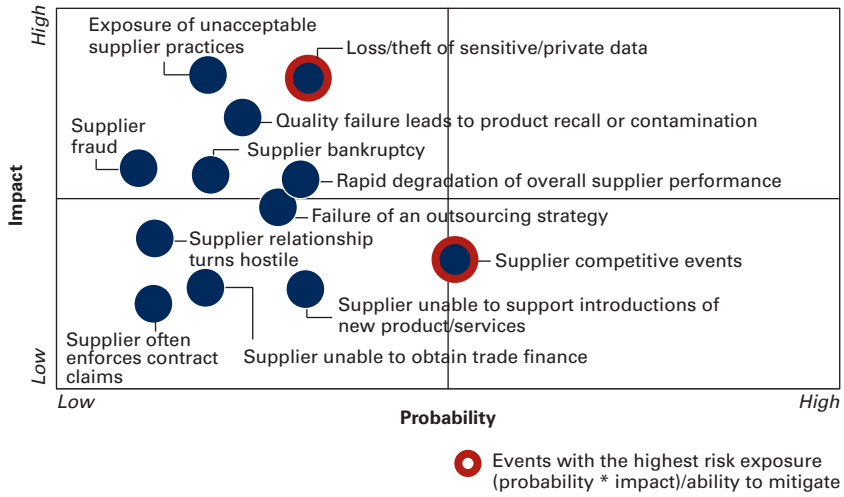
In addition to the most commonly recognized supplier-related hazards, potential risks include:

- Supplier inability to obtain trade finance.
- Quality failure leading to product recall or contamination.
- Rapid degradation of supplier performance (cost, service, response time).
- Supplier inability to support new product/service introductions.
- Frequent enforcement of contract claims and change penalties, leading to work stoppages (e.g., supplier submits low bid to win business, then increases costs to remain profitable).
- Relationship turns hostile, exploitive ("take it or leave it" price increases, discontinued support/maintenance, new orders refused, existing supply contracts terminated to negotiate better terms).
- Failure of an outsourcing strategy (unmet expectations on costs, customer satisfaction, productivity, quality).
- Supplier competitive events (acquisitions, mergers).
- Unacceptable supplier practices (violations of immigration law, sweatshop conditions, unsustainable environmental waste, tax evasion).
- Loss/theft of sensitive/private data.

* *Adapted from* A Short Guide to Procurement Risk. *© Richard Russill 2010*

Fig. 9 plots the likelihood of specific events against their potential business impact. The heat-map format makes it easy to identify areas needing attention. Companies should work to move high-risk events down to a lower risk profile in an effort to decrease their bottom-line impact. Once risks are understood, it is possible to assess whether and how to minimize or avoid them. Making risk assessment a quantifiable exercise allows buyers to determine when the value delivered exceeds the costs and resources required to manage the risk. In some cases, it will become clear that it is better to accept the risk because the mitigation plan is too expensive or risky itself.

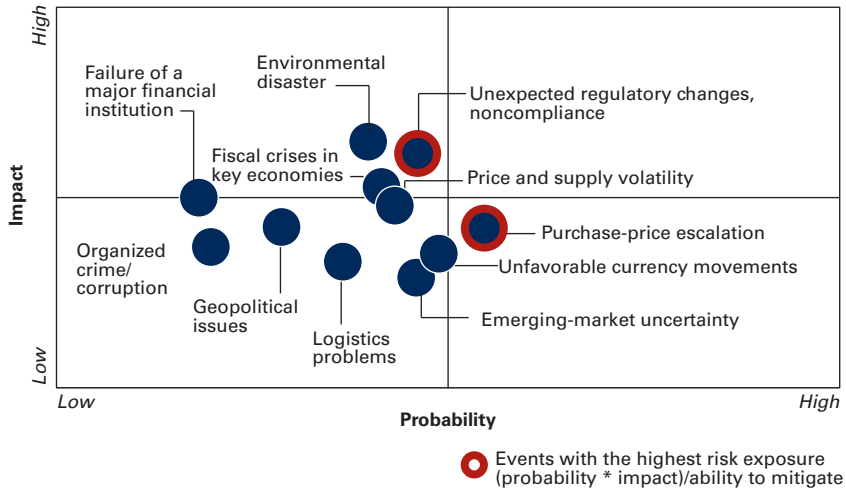
FIG. 9 Supplier risk events



External market risks

The slowing economy in Western Europe and North America has encouraged many companies to look to developing markets for growth. There, opportunities abound but they are rife with hazards which must be carefully managed (Fig. 10). National and global legislative efforts aimed at reducing corruption by instilling more transparency have put procurement organizations on the front lines, where they must not only help their companies sidestep risk events but also remain in compliance with new legal and regulatory guidelines.

FIG. 10 External market events



Early warning signs of supplier difficulties

- Experiencing shortages of raw materials; late purchase-order placements.
- Cutting investments in R&D, IT, equipment or resources.
- Quality of supply is deteriorating.
- Staff being laid off.
- Offering discounts for early payment or requiring payment in advance.
- Restated earnings or outlooks.
- Making heavy investments in new products that are delayed.

External risk types:

- Fiscal crises in key economies.
- Political or economic uncertainty in developing nations.
- Organized crime.
- Official corruption.
- Price and supply volatility.
- Unfavorable currency movements.
- Environmental disasters.
- Unexpected regulatory changes.
- Logistics problems (e.g., port congestion, piracy/theft, damaged goods).
- Other geopolitical issues (e.g., labor unrest, watchlists, conflicts, terrorism).

Conclusion and Recommendations

Globalization has raised the criticality of risk management. Given cost pressures and the importance of supply chain operations to the business, we expect world-class companies to move toward proactive risk management practices, as opposed to continuing to simply react to risk events when they happen.

Having the correct staff skills to design and execute the supply risk strategy is essential. We see world-class organizations actively changing or bolstering their staff profiles to alter the balance toward necessary strategic sourcing skills and away from mundane transaction processing. For most organizations, gaining visibility into their own risk profile is the first step. This must be aligned with the goals and interests of various stakeholders – the budget holders, the company's clients, senior management and so forth. For some, the primary risk will be one of supply disruption due not only to supplier fragility but to global supply lines, natural disasters and potential for terrorism. For others, the leading risk may be price fluctuations, for example in commodities where scarcity may occur or monopolistic practices may cause difficulties. Once these insights are achieved, documented and categorized, companies can begin to prioritize efforts – such as financial hedging – to mitigate risk, aligning resources and investments to the areas of greatest vulnerability or highest ROI potential.

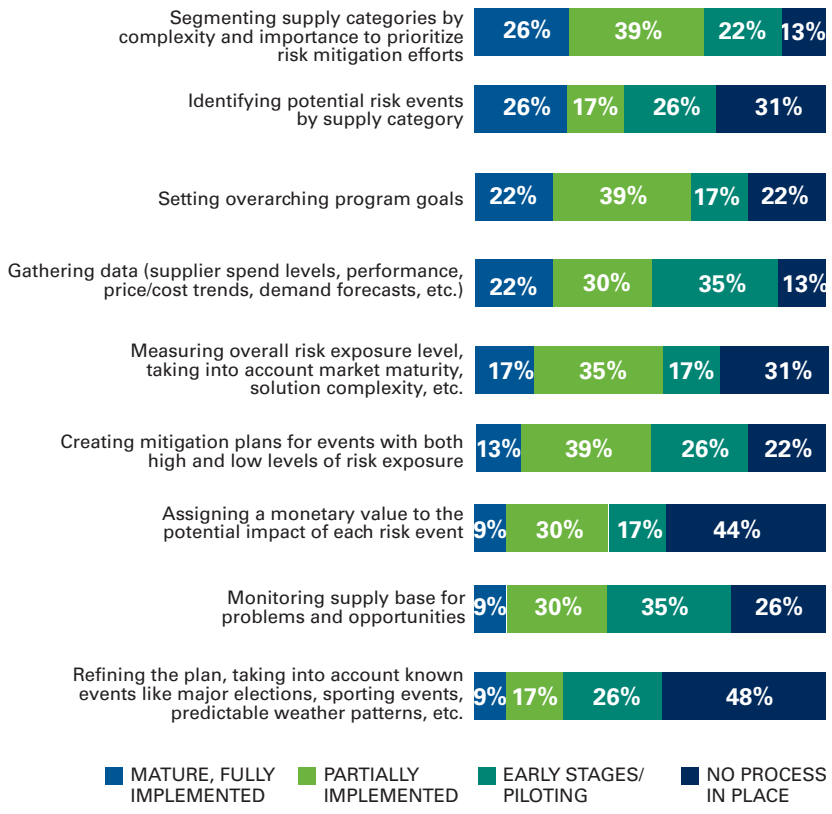
We believe that the following are the foundational elements of a successful supply risk management approach:

- Risk management should be cross-functional: This is not only because of the stakeholder buy-in that is required, but also because the company's view of risk exposure to events can differ depending on the areas/functions involved. Separate areas of a company can assess and develop their own risk mitigation strategies, but if they consider only the view within their own silo, they might miss something and not consider the overall picture. The total company's risk exposure to an event is the result of all the interactions and activities created across the enterprise – for example, the views of procurement and manufacturing (supply chain risk) versus finance (DSO, DPO, payment terms, etc.) and even R&D.
- Identify and leverage the "burning platform": This helps obtain support from the business for the new or revised process, whether it's safety, security or some type of business-continuity platform. Always ask the question, "What are you trying to protect?" when trying to get the business to articulate which operations and metrics the risk management activities should link to.

- **Use supply intelligence and scenario planning:** These tools identify the universe of potential supply-risk events (including both frequency and severity), answering the questions, "Where and why are we at risk?", "How high is the risk?" and "How likely is the risk?" Identify both internal and external risk factors, as well as where more information is needed to home in on the primary risks. Formally document the findings and, more important, ensure that key stakeholders understand and accept the findings.
- **Identify potential risk mitigation and contingency steps required:** This will help avoid or at least minimize the frequency and severity of the risks. Know the risk position and associated costs by developing options with associated timelines, resourcing and costs. Make sure that stakeholders understand the mitigation strategies developed and their implications (for example, "Do nothing" is also a potential strategy). If none exist already, establish risk-tracking metrics with stakeholders. For example, use a composite metric at the senior management level, such as "profit at risk," to bring continued visibility to the issue, and also make sure that procurement's scorecard itself is also updated to reflect a concerted focus on risk management.
- **Gain stakeholder buy-in (and funding) and implement the chosen interventions:** In order to show progress, make sure that there are measurable "causal factors" that are baselined and then measured post-implementation. This is in addition to stakeholder output metrics that have been defined and linked to. Also, include risk mitigation activities that can also yield some cost savings, especially in the initial phases.
- **Measure and monitor the changes and benefits from the new process:** Make sure to document successes and use them to continue the momentum. Again, make sure that the measurement systems are updated in order to keep risk management top-of-mind. Remember that the objective of risk management is avoiding or minimizing risk, and therefore ultimate success should be assessed based on the impact (revenue, profit, market share, etc.) on the business.

Organizations are most mature in the early stages of the lifecycle, less so in continuous improvement and refinement (Fig. 11).

FIG. 11 Process maturity levels across the supply risk management lifecycle



Source: Supplier Management: Managing Relationships and Risk Poll, The Hackett Group, 2018

Related Hackett Group Research

World-Class Procurement: Redefining Performance in a Digital Era, May 2019

Enterprise Spotlight Report: Master Data Management, April 2019

Leveraging Digital Tools in 2019 to Expand Procurement's Capabilities, January 2019

About the Advisors

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Ms. Fong has 20 years of experience in industry and consulting with a focus on procurement, supply chain and organizational effectiveness. She helps business leaders improve source-to-pay processes, manage complex supply chain partnerships and mature their organization's service delivery model. She also performs primary research in source-to-pay and operations and is the author of a number of publications on these and other topics.

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Mr. Sawchuk leads The Hackett Group's global procurement advisory practice. He has over 20 years of experience in supply management, working directly with the Global 2000 and midsized companies around the world and in a variety of industries to improve all aspects of supply management, including process redesign, digital enablement, operations strategy planning, organizational change and strategic sourcing. Mr. Sawchuk specializes in working directly with CPOs to help define a long-term strategy. He is a regular contributor to business publications, a frequent presenter at industry events and author of numerous reports and books. Mr. Sawchuk's background includes engineering, operations and sales roles with both United Technologies and IBM.

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