Analyzing the supply base is a critical part of risk management. But purchasing can do much more—like serve as a bridge to connect departments and question basic assumptions about company operations. By Paul E. Teague

The RISK

You've heard the expression "Do as I say, not as I do." It seems that it applies in business as well as personal affairs. A good example is in the graphic below. The left part of the graphic shows what procurement executives in a wide range of global companies told international supply chain consulting firm BrainNet were the risks that had the highest damage potential for their companies. The other shows what those same procurement execs focus their risk management efforts on. Notice the disconnects?

Okay, a slight disclaimer: BrainNet did the study in 2007. Presumably, the damage-potential rankings would be different today. Also, it's certainly reasonable that some risks, like loss of intellectual property, may be long term and therefore not warrant immediate attention. Still, the disconnects point out the need for procurement professionals and other risk managers in corporations to think about how they set their priorities.

The top priority for action, at least according to that 2007 BrainNet study, is supplier risk. BrainNet confirmed the emphasis on suppliers in a short follow-up survey in January 2009, which showed "supplier rating" as procurement's top risk-management activity.

Supplier risk is practically a timeless concern: Procurement professionals have worried about supplier performance and stability since the beginning of the industrial revolution. But with the flood of bankruptcies resulting from the credit crunch and general economic weakness, those worries have taken on ulcer-inducing proportions.

Understandably. Other studies have shown that almost 20% of procurement respondents had suppliers who had not been able to meet their supply levels or needs. The lesson is that purchasing professionals have to more closely monitor the financial stability of their suppliers, including supplier liquidity and changes to suppliers' customer-priority rankings.

There is evidence that other functions within organizations are recognizing the role of purchasing in overall risk management. In a recent study by *Purchasing* and software provider Ariba, more than half of the respondents, all of whom had responsibility for some aspect of procurement, said their CFOs expect them to deliver information for managing risk. And that January 2009 BrainNet follow-up study showed that CPOs continue to gain status as opinion leaders in supply chain risk management.

But there is much more that procurement professionals should be doing beyond monitoring suppliers, says Steven Minsky, CEO of software provider LogicManager, and author of a new report on enterprise risk management (ERM). "Because purchasing professionals interact with so many other people within their organizations, they should lead the effort to broaden the thinking about risk management," he says. In fact, they could be

Risks that procurement thinks have high damage potential

Loss of intellecutal property	55%
Outsourcing	53%
Supply risks	52%
Compliance	44%
Supplier risks	41%
Raw material prices	39%
Energy price risks	32%

Source: BrainNet

disconnect

a bridge that connects other departments that analyze risks.

Supplier risks

Of course, for procurement, it all starts with supplier risk. Efforts to manage supplier risk follow a similar pattern at most companies. There is the due diligence of verifying a supplier's product quality, reliability in on-time delivery, financial stability, technology planning and development and the supplier's own risk-management strategies. And, there is the cost analysis to ensure that the supplier isn't charging more than an industry norm so buyers don't risk paying too much for the materials they need.

IBM Chief Procurement Officer John Paterson spends a lot of time with his staff on risk management. "It's critical to understand risks in all parts of the supply chain so you can build mitigation strategies," he says. The strategies can be as simple, he says, as setting up second sources of supply. Craig Brown, who leads purchasing at Intel, advises procurement staffs to "find another supply source or site even it's owned by the same supplier."

Brown and his team realized the benefits of second-source planning when a fire destroyed a factory of a primary source. "Within 24 hours, we had re-mapped the product line to a different set of suppliers," he says.

Analyzing primary suppliers is only part of effective risk management, says Eric Johnson of Dartmouth College's Amos Tuck School of Business. It's critical to extend that analysis to tier two and tier three suppliers too, he says. "You have to build that analysis into the second tier supply base," Johnson says. That's because slip ups at that level can make it more difficult if not impossible for primary suppliers to perform up to expectations.

Taking the time to understand how your suppliers' businesses work also helps to mitigate risks, says Matt Enderwick, assistant dean for finance and administration at North Carolina State University in Raleigh, N.C. "Look at the decisions they've made and what they're doing to turn a profit," he says. "A lot of companies facing pressures to grow, branch out to things they're not good at, and that brings profits down."

But LogicManager's Minsky says purchasing has to ratchet up its supplier-risk thinking to a higher level. For example, he says, while concern with having only a single source of supply is legitimate, the bigger issue may be over reliance on custom-designed parts. "Purchasing should be asking engineering, "why did we design the product this way?" he says.

Risks that procurement focuses on

Supplier risks	86%
Supply risks	61%
Compliance	60%
Raw material prices	49%
Loss of intellectual property	45%
Energy price risks	42%
Outsourcing	41%

The risks that procurement considers to have the highest damage potential aren't necessarily the ones they focus most of their time on.

"It's critical to understand risks in all parts of the supply chain."
—John Paterson, IBM

Minsky offers this case in point: "Apple once designed its own hard-drive bracket. There was no added value from the bracket. A standard off-the-shelf bracket would have done fine. The custom design caused a bottleneck in the supply chain."

That kind of custom design in lieu of standard parts is common throughout many industries and has driven purchasing managers as well as manufacturing managers to distraction. There may be legitimate reasons for specifying special versus standard parts. But purchasing, Minsky says, is in the best position to question engineering on why they are boxing the company into custom designs, and by extension, potentially longer leadtimes.

ERM: The next step

Asking questions like that elevates purchasing's role and expands it into the realm of enterprise risk management. "Solving a risk problem in just one silo only sends the problem to another silo," says Minsky. "Purchasing can help identify who in the corporation needs to be involved in the solution to truly lessen a risk."

The reality is that a lot of people have to be involved—and talking to each other. There have been several situations that prove the point. In one, ExxonMobil was accused of discharging more than 15,000 gallons of kerosene and low-sulfur diesel fuel in Boston's Mystic River. The cause was defective valves. Previously, a contractor had pressure-tested one valve and found that it leaked. The company did not replace the valve, which allowed fuel to leak into a second area where a corroded relief-valve coupling failed, ultimately spilling fuel into the waterway. The U. S. Department of Justice said ExxonMobil was negligent, and that finding cost the company more than $6 million. Among the problems, Minsky says, was the fact that the right people who could have taken action did not know about the contractor's report or the corrosion on the coupling. Someone should have been in charge of making sure everyone knew of the problem and who was responsible for making repairs. Purchasing, because of its interaction with all the groups in the company, would be in a good position to facilitate the communication.

In fact, Lars Immerthal, head of the risk management practice at BrainNet, is already encouraging that view in a variety of industries. "We encourage clients to build up a competency center on risk and bring all the departments in the company together," he says. "Depending on the standing of the CPO within the company, purchasing can be the leader of the competency center."

"Find another supply source or site."
—Craig Brown, Intel

False sense of security

Even companies that think they have effective risk-management practices in place can come up short, as Minsky's study showed. The study, for the Risk and Insurance Management Society (RIMS), surveyed 564 corporate risk practitioners, many with purchasing titles. Respondents assessed their own risk-management strategies against 68 guidelines that are part of RIMS' Risk Maturity Model for ERM. Among those guidelines: executive support for ERM, inclusion of risk-management competence as part of managers' performance reviews, whether risk assessments are conducted in all business groups and whether front line managers identify risks for their business areas and develop risk-mitigation activities.

The study revealed that 93% of organizations with formalized ERM programs make better risk-informed decisions. But it also showed that only 4% of companies

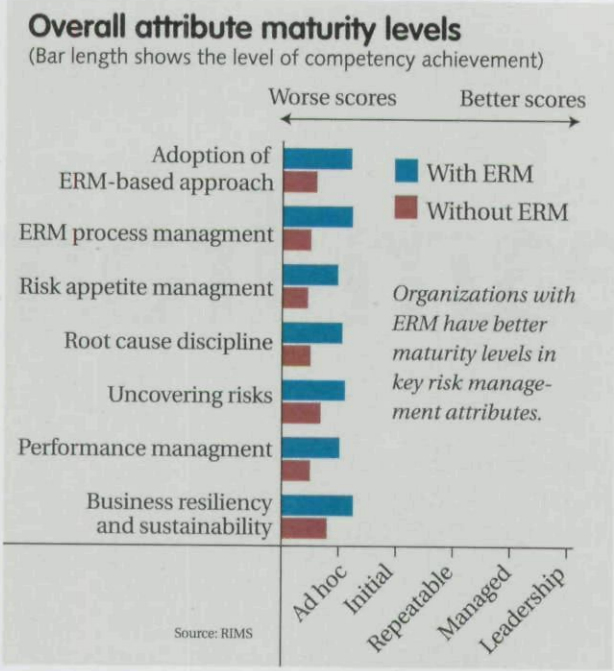
WHAT IT MEANS TO BUYERS:

- Purchasing professionals have an opportunity to fill a risk-management void by serving as a bridge between departments for risk assessment and mitigation strategy.
- Procurement should raise its risk-assessment thinking to a higher level. For example, beyond identifying potential risks and solutions to use of a single source, purchasing should question the business reason for requiring a customized part available from only one or two suppliers.
- Risk-management priorities don't always match potential risk severity. Purchasing should analyze why.

Where companies fall short in risk management

The Risk and Insurance Management Society's ERM study showed that companies with formal ERM programs make better risk-informed decisions. But it also showed that even with ERM in place, companies can fall short of their risk-mitigation potential. Here are some of the initiatives that many companies practicing ERM still have not implemented:

- Collection of risk information from all processes, especially from front-line management.
- Detection of cross-departmental effects and dependencies.
- Linkage of risks to corporate goals and objectives.
- And comparison of actual risk to assessed risk.

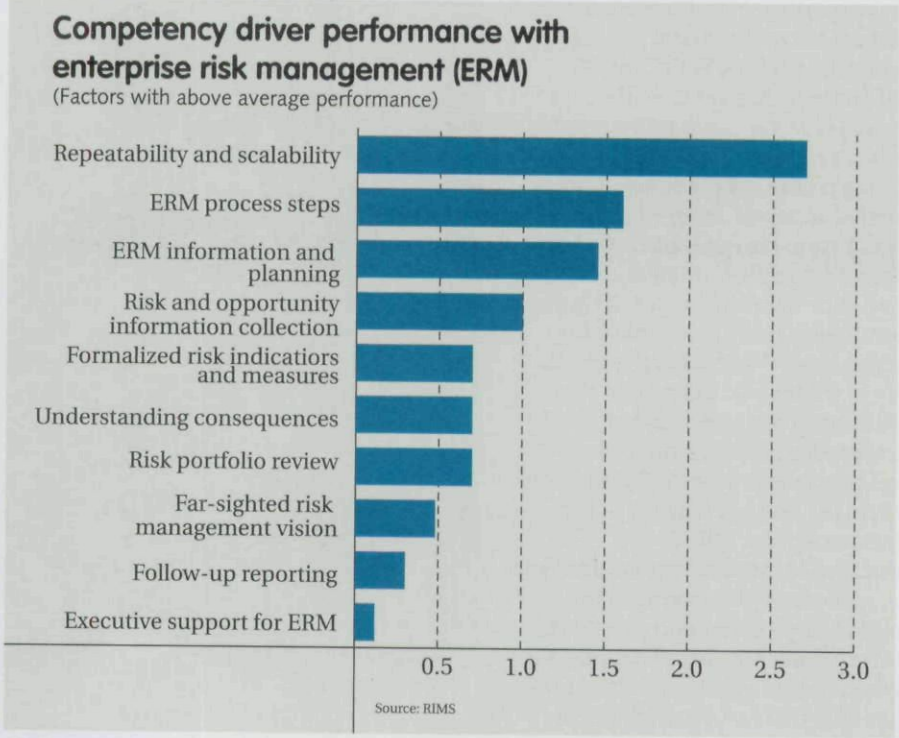


with an ERM program have achieved an adequate level of risk-management competency in all risk areas. "This shows that organizations may have a false sense about all that is required for an effective risk-management program," Minsky says.

While the study shows a correlation between companies that score high on risk maturity and companies that have high credit ratings, it also validates many of the supply-chain risk-management strategies purchasing follows, such as aggregating all supplier information in one place. But it also shows that purchasing may have to give a higher priority to risk when it adopts a strategy of reducing its supply base. "Purchasing has to think through tradeoffs in reducing the quantity of suppliers to gain purchasing power vs. the hidden increased risk in reduced quality, stability, flexibility and innovation," Minsky says.

"Think through the tradeoffs when reducing suppliers."
—Steve Minsky, LogicManager

The study also shows that purchasing has an opportunity to broaden its influence in companies by using its interaction with engineering and manufacturing to heighten awareness of risk and bring those and other departments together to solve critical operational business problems with a risk-based approach. The RIMS ERM study shows that mathematically companies are eventually going to get nailed by some of the risks they face. Purchasing can help lower the risk by bringing different functions within their companies together to understand the risks and take action before they happen. □



Competency drivers where companies have made the most progress in enterprise risk management.

To access the RIMS risk-assessment model and measure your company's risk-management maturity, see www.purchasing.com/risk.

How to monitor suppliers for risk

The Procurement Strategy Council recently issued a white paper on what buyers should look for when assessing the risk potential of suppliers. Here are some of the factors:

- Supplier financial data, including cash flow, change in share value, net working capital ratio and changes to payables and receivables ratios.
- Supplier operational performance, including delivery and defect rates.
- Movements in bond and credit markets and credit agency reports.
- Health of suppliers' other large customers.