Risk Management in Purchasing and Supply Management

Risk management and incentivisation, a subject on which CIPS has developed a separate practice document, are techniques that can be applied separately or together to ensure that contracts are successful. CIPS encourages all purchasing and supply management professionals to constantly exercise a ‘what-if’ mentality in relation to the procurement of goods, services or works. The ‘what-if’ mind-set will enable purchasing and supply management professionals to determine the potential outcome of risk management and incentivisation by testing assumptions, propositions and approaches under consideration.

CIPS Positions on Practice

CIPS views, opinions and beliefs are stated throughout the document; however the broad practice statements which underpin the text are as follows:

- Risk management is a fundamental aspect of purchasing and supply management and one with which all purchasing and supply management professionals should be familiar.
- CIPS considers that when carrying out whole life costings, purchasing and supply management professionals should be alert to the risks associated with each stage of the life cycle.
- CIPS takes the view that it is best to allocate risks to the person or department best placed to manage them effectively.
- CIPS believes that the purchasing and supply management professional should do his/her best to minimise areas of concern as seen from the supplier's viewpoint.
- CIPS firmly believes that purchasing and supply management professionals are under an obligation to understand the corporate objectives and ensure that the procurement strategy is in line with these.
- CIPS considers that risk awareness should be seen as a positive attribute as far as purchasing and supply management professionals are concerned; it should not be interpreted as an expectation that things will go wrong but rather as being prepared for the fact that they may do so.

Risk Management

CIPS suggests that risk can be defined as 'the probability of an unwanted outcome happening'. Risk management involves three key activities: risk analysis, risk assessment and risk mitigation all of which facilitate the taking of decisions and actions to control risk appropriately by providing a disciplined and objective approach.

Risk Analysis

Risk analysis is the process of identifying all the potential things that can go wrong with an activity, and then estimating the probability of each happening.

Risk analysis is part of the strategy development process. When a need is identified, a strategy is developed having taken into account all relevant commercial issues, such as specification, supply market and finance. A risk analysis methodology allows all the risks to be identified and objectively assessed. The purchaser can then decide on an appropriate sourcing strategy. Once the sourcing strategy is decided, the contract strategy can then be formulated - it is at this stage that a decision of whether a risk/reward type contract is appropriate.

CIPS considers that risk analysis should be part of any significant purchasing and supply management process; it is a fundamental activity of use in for example, determining the overall strategy, to individual plans for categories of expenditure, sourcing and, even, if appropriate, tactical procurement. It is a key skill of any purchasing and supply management professional and is necessary to minimise commercial exposure.

The analysis can, however, be a simple, or a very formal process. The latter approach is more appropriate for high-value and high-risk projects such as a new IT solution - and may involve following a set procedure, working cross-functionally with colleagues, brainstorming and risk evaluation. Analysis can also be informal, using an iterative or intuitive process, for less significant procurements, or it may even be reactive, such as in response to a crisis for example.

There are no golden rules of best practice in risk analysis - the key is to be able to identify all the risks relating to a particular procurement including the impact of that procurement on the business, and to decide what level of effort is appropriate to the circumstances. For more complex situations, the risks can be brainstormed and categorised into groups such as ‘technical risks’, ‘financial risks’ etc. Alternatively a more detailed approach may be adopted. In some public sector areas, particularly for IT or PFI projects, there are quite specific analyses to be undertaken, and failure to address all aspects fully can result in rejection of the procurement by a higher authority such as the Treasury.

The second stage is to assign a level of probability to these risks. Some methods express the impact of the risks and the cost of controlling them and so decisions on trade-offs can be made. As stated in the introduction, CIPS has developed an approach for risk analysis.

Risk Assessment

This is the process of assessing the likely impact of a risk on the organisation. Highly predictable risks may have low impact and therefore it is possibly not worth taking any action to control or avoid the risk. On the other hand, low probability risks can have a significant impact and some form of action may be demanded ‘just in case’. The cost of controlling or avoiding the risk needs to be taken into account.

It may be that some risks are not very easily controlled or managed. These may fall into the category which needs to be insured, if indeed the insurance market is prepared to insure them. The process of risk assessment is not all encompassing, as there is usually a degree of uncertainty. This uncertainty increases as the probability of the unwanted outcome reduces. Uncertainty can be addressed by ‘sensitivity analysis’. This involves manipulating the variables or assumptions e.g. events that can lead to the unwanted
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occurrence, to see the effects of these. It can illustrate where the outcomes may be different if some assumptions are incorrect.

Another point to consider during risk assessment is ‘compensating behaviour’, which is where people, aware that a particular risk is being controlled or managed, ‘compensate’ by doing more of the unwanted behaviour, thereby increasing the risk. An example would be insuring lap top computers - where lap top computers are insured against loss or theft, some users take less care and for example, leave them in their ears overnight.

Risk Mitigation

Having assessed all the risks and identified those that require action, plans need to be drawn up and responsibilities assigned to control and mitigate these risks. Risks then should be allocated an owner, who is responsible for managing them, possibly with the help of other team members.

The allocation of risk should be dependent on the assessment of the likelihood and consequence of the risk and then the identification of who is best able to control or manage the risk. This is an important aspect of any significant procurement and so something in which purchasing and supply management professionals should be involved.

Having allocated the risk, the issue of what is a fair reimbursement mechanism is a related but separate issue. Like all reimbursement it should be fair and reasonable. Forcing vendors to assume risks they cannot control by offering an incentive or a reward is not good practice.

It should be remembered that risks change over time. Risk assessment should be iterative. CIPS recommends that when undertaking whole life costing, purchasing and supply management professionals should identify the relevant risks associated with each stage in the life of the product; thus in some cases, risk might increase dramatically towards the end of the life cycle due to problems of disposal or obsolescence.

A route to risk mitigation is insurance. CIPS suggests that purchasing and supply management professionals ascertain what insurance arrangements their organisations have in place as some risks may already be covered by insurance; equally insurance may no longer be necessary for some aspects if the risks can be managed properly. Similarly, new insurance policies may be required to reflect different approaches to contracting strategy.

Risk can be transferred to suppliers. However, risk mitigation is a calculated trade-off. Too much risk transfer to a supplier will simply lead to cost increases as the supplier seeks to lay off the risk. Insufficient transfer of appropriate risk leads to the buyer accepting a disproportionate amount of the risk, which might be better accepted and managed by the supplier.

CIPS’ position is that risks are best allocated to the person or party best able to manage them. This may be in terms of expertise, time and/or resource. Where this is a supplier, or another third party, purchasing and supply management professionals should be mindful of the fact that suppliers will build in extra safety and extra margin. An effective buyer will try and identify and ameliorate areas of concern. Often this can be done in discussion with the supplier and involves little if any cost or compromise on behalf of the buyer.

Risk From The Viewpoint Of The Supplier

If the supplier perceives risk to be high he will naturally build in extra safety and extra margin. An effective buyer will try and identify and ameliorate areas of concern. Often this can be done in discussion with the supplier and involves little if any cost or compromise on behalf of the buyer.

The Role of the Purchasing and Supply Management Professional

CIPS holds that the purchasing and supply management professional’s role is to:

- identify and promote the business need for risk management in procurement
- identify who in their organisation is/should be responsible for this
- work with them in analysing and assessing the risks
- inform himself/herself sufficiently about the supplying organisation(s) and the people involved to make discretionary judgements about the balance of probability of the supplier causing or allowing risks within their own control, to materialise
- make a value-added input to commercial decision by leading a commercial risk assessment in the development of commercial strategies
- be fully conversant with a range of contract strategies that can be applied when setting up contracts to achieve best value in meeting organisational objectives.

Various purchasing and supply management techniques can make a substantial contribution to this process, for example supplier appraisal or tender evaluation can minimise the risk of using unsuitable suppliers.

Where there is no-one identified as responsible for risk management, the purchasing and supply management professional should communicate probable risks to colleagues such as the sales person who deals with the external customer, the budget holder, or finance director. They should seek to challenge assumptions and encourage colleagues to manage risks. Where there is little interest, the purchasing and supply management professional should take responsibility for all significant procurement risks and document these accordingly e.g. assessing a new yet significant supplier’s financial standing, taking references etc. Such initiative should help build trust and professionalism within the organisation.

With respect to wider business issues, such as risk to reputation for instance, CIPS would advocate that as a purchasing and supply management professional is an external face in the organisation, he/she has a responsibility to feed into the organisation anything they detect which may generate a risk to the business. As is regularly stated, CIPS firmly believes that all purchasing and supply management professionals have a responsibility to understand the objectives of their organisation and to ensure that the procurement strategy is in line with the corporate strategy.
Skills Required

CIPS believes that in order to undertake risk management, the purchasing and supply management professional should have:

• a knowledge of the risk management techniques available
• an analytical mind-set
• objectivity
• confidence to ask the right questions
• knowledge of their employer's business and market.

Like many skills, effective risk management improves with experience and so, with practice, knowing how far to analyse and assess risks will become easier, if not intuitive.

Conclusion

Organisations are increasingly aware of the importance of managing risk and high profile reports such as that by Turnbull, September 1999 (Internal Controls: Guidance for Directors on the Combined Code) have contributed to the interest. CIPS believes that purchasing and supply management professionals can add value to any risk management process within an organisation, whether or not it is directly related to purchasing and supply management.

This practice document has stated that risk management is another invaluable technique; CIPS believes that an awareness of risk should be regarded as a positive trait in the successful buyer - it needs to be seen not as an expectation that things will go wrong but rather as an alertness to the fact that they might do so, coupled with a readiness to take positive steps to prevent undesirable outcomes.

Of course CIPS recognises that not all buyers are equal. Significantly, the skills and competencies identified in this policy a being necessary for the management of risk are generally viewed as being of pivotal importance in other areas of purchasing and supply management.