Risky Business – an introduction to procurement risk management
The CIPS paper “The TOP 3 Issues facing the procurement profession” published in 2005 found that the major issues facing the procurement profession, included how it could demonstrate value to a CEO’s strategic agenda, by contributing to the reduction of business risk; and to ensuring that both strategic and commercial aspects were adequately considered with outsourcing decisions.

This paper focuses on procurement risk management with an emphasis on the importance of procurement to an organisation’s strategic agenda, and the value the procurement profession can deliver to strategic commercial decisions. This includes contributing to decisions, such as the outsourcing of business processes and functions, that in some organisations may be taken without the involvement of procurement expertise.

Risk Management is integral to good procurement practice, as it is to good enterprise management. Through its application an organisation will better understand:

- The risks and opportunities to which it may be exposed through procurement, and
- how procurement strategy, practice and process can be developed and implemented to ensure those risks are managed effectively.

The key themes of this paper are that:

- Risk management is an integral part of procurement;
- effective risk management requires an understanding of the relationship between procurement and organisational objectives; and
- procurement professionals are well positioned to play a significant role in improving an organisation’s risk management practices, through contributing their expertise as strategic and commercial risk managers.
Defining Risk and Risk Management?

The widely accepted Australian/New Zealand Risk Management Standard (AS/NZS 4360-2004) defines risk as:

"the chance of something happening that will have an impact on objectives."

The Standard qualifies this statement through three important notes1:

1. Risk is often specified in terms of an event or circumstance and the consequences that may follow from it,
2. risk is measured in terms of a combination: consequences of an event and their likelihood, (and)
3. risk may have a positive or negative impact.

In this context the standard defines Risk Management as “the culture processes and structures that are directed towards realizing potential opportunities while managing adverse effects”.

Risk Management is also a professional discipline with its own specialised knowledge and skills, that assists organisations to identify, assess and treat potential and actual events that may have a negative (or positive) impact on outcomes or objectives. There will be times when the procurement professional will need to call upon the expertise of the risk management professional.

Procurement Risk Perspectives

Procurement, as the acquisition and management of external resources, is a function of strategic and operational importance to any organisation in a modern economy. This is equally the case whether it is managed by procurement professionals through a central procurement organisation or distributed organisationally on some other model.

Procurement’s role is to ensure that an organisation has a predictable supply of the external input/s it requires, offering demonstrable value for money and delivered in a cost-effective manner to support the attainment of the organisation’s objectives. While its traditional role is in dealing with upstream suppliers in a supply chain context, it may also deal with downstream transactions, e.g. for logistic support in distribution of finished product.

By its nature, procurement exposes an organisation to risk. Procurement practices have, for this reason been developed with inbuilt controls designed to deal with that risk, for example purchasing through public or selective tendering, in the right circumstances, will encourage competition and diminish the scope for corruption and collusion in acquisition processes.

Risk in procurement, however, is often considered from a transactional viewpoint where risk management is focused on the things that can “go wrong” in the procurement process. This view is concerned with events that may contribute towards:

■ Breakdown in process;
■ failure to comply with required processes; and,
■ inadequacy of process to achieve the commercial outcome required.

1 Australian/New Zealand Risk Management Standard (AS/NZS 4360-2004), p 4
Although this perspective is valid and important, it does not address the strategic objectives of the procurement function, or core business of an organisation. It is generally the concern of those who are direct stakeholders or practitioners in the process. It is generally not seen by Boards, CEOs and Senior Executives as a matter that requires their attention, unless it arises in the context of a project of strategic importance or as an issue in corporate governance.

A major factor leading to a greater focus on risk management in the procurement context is the blurring of organisational boundaries, through:

- Increasing use of a “contingent” workforce, i.e. contractors rather than employees;
- outsourcing of transactional and operational functions, including business processes and logistic services to achieve strategic, competitive, and commercial advantages; and,
- the establishment of collaborative relationships with suppliers and customers as integral members in the overall supply chain.

In adjusting to this commercial environment, it is essential to complement a process view, where risks are identified and treated as isolated events, with a holistic view of risk where procurement and organisational objectives are considered together and their interrelationships and associated risks are addressed. This higher level approach will identify opportunities to add value through systems, including shortening lead times, reducing inventory holdings, and supporting the development of new market opportunities for the business.

The integration of best practice in risk management will better position the procurement professional to manage stakeholder expectations, and facilitate outcomes that are within the risk tolerance of the organisation. Risk Management, applied effectively, will assist the procurement professional to identify changes to the procurement environment, implement treatment plans and reengineer cost effective procurement process to mitigate risk.

The consequences of not managing procurement risk effectively can include:

- Discontinuity in the supply of essential goods or services,
- avoidable increases in project costs and in the unit costs of purchased inputs, in both the immediate and longer-term,
- loss of power and influence in relationships with essential suppliers,
- loss of market share or revenue through inability to meet customers demand,
- cash flow problems,
- procurement outcomes that do not support organisational needs and objectives, e.g. that undermine an organisation’s ability to respond with agility to changing circumstances,
- opportunity for fraud and corruption,
- negative impact on reputation in the market place,
- exposure of Directors and Officers to prosecution and litigation, and
- failure in Corporate Governance and compliance controls.
In the extreme, crystallisation of a significant procurement risk can cause a business or organisation to cease operation.

There are many benefits in the effective integration of risk management with procurement, but there are three that would be almost universally achieved:

- Smarter procurement decisions – achieving both financial and non-financial benefits;
- Fewer surprises, and better identification and achievement of stakeholder expectations through acknowledgement of risks; and,
- Better procurement outcomes for buyers and suppliers, satisfying the commercial and relationship needs of both parties.

**Risk Management Process**

The Australian/New Zealand Risk Management Standard 4360:2004 (AS/NZS 4360) provides a generic framework for the management of risk, as shown in the following diagram.

The critical elements of the Standard are:

- Establish the context,
- Identify the risks,
- Analyse and evaluate the identified risks, and
- Treat the risks

The process that the Standard describes requires on the one hand ongoing communication and consultation and, on the other, continual ongoing monitoring and review.

The Standard itself is not static but has continued to evolve since its inception. Key features of the 2004 edition included:

- Strengthening links between risk management and strategic planning,
- Emphasising the importance of the key first element ‘Establish the Context’, which is crucial to the proper application of the Standard,
- Removing material including standard risk matrices, that had had the undesired effect of encouraging a “cookery book” approach to the application of the Standard.
Effective application of AS/NZ 4360 for any purpose requires establishment of a specific context. This context defines the basic parameters within which risk must be managed, and sets the scope for the rest of the risk management process.

As previously noted, there are three distinct and essential elements to a risk:

- An event or circumstance;
- its likelihood; and
- its impact (consequence) on the attainment of objectives.

No event is a risk for an organisation in its particular context unless it has an impact on the organisation’s objectives. It is therefore vital in any particular context that there is a shared understanding of organisational, procurement and stakeholder objectives.

It is equally important that the procurement objectives be aligned with the objectives of the broader organisation. Should there not be alignment, the effectiveness of both the procurement and risk processes will be diminished and there will be a significant risk that corporate objectives will be compromised.

As an example, an organisation seeking to be more socially responsible needs to reflect this objective through its purchasing policy, practices and procedures.

Linking procurement and organisational objectives will lead to alignment and shared understanding of what constitutes success for the organisation, and for specific procurement activity. For example an organisation that has as an environmental management objective of a 20% reduction in greenhouse gas emissions needs to give due consideration to energy efficiencies that may be achieved from vehicle, equipment and energy purchases.

In establishing the context for risk management, it is also important to consider both internal and external stakeholders and their respective objectives. For instance, the purchase of a fleet of hybrid motor vehicles may contribute towards the reduction in greenhouse gas emission but it also needs to satisfy the transport requirements of the internal stakeholders.

The following diagram shows the relationship between organisational objectives, procurement strategy, activity and process. At level 1, the highest level, the organisation’s risk management approach is applied to the attainment of corporate objectives through the development and alignment of procurement strategy. The next level is concerned with procurement risks within specific procurement activities that may diminish the ability to deliver the broader and specific procurement objectives. At level 3 a process view of risk is applied where risk management is concerned with weaknesses in control and process that may diminish the organisation’s ability to achieve the objectives of specific procurement activities.
The Australian Standard advocates disaggregating the relevant context into its logical elements before proceeding to risk identification. Establishing the context at strategic, operational and process levels will ensure appropriate participation and enhance creativity, as it will allow a higher level of engagement during the risk process. It also ensures the risk context and evaluation techniques are appropriate to the types of risks being considered.
Risk Identification in the Procurement Context

Risk identification is a systematic creative process that takes place within the established context. It is not an easy task and will require, at times, the identification and acknowledgement of risks that may be uncomfortable for an organisation to confront. It will generally require a team with a range of skills and knowledge. At the Strategic level, organisations may also need the assistance of a skilled facilitator to do it well. It is important to consider all relevant risks whether or not they arise inside or outside the organisation, and whether or not they are under the control of the organisation.

The approach to risk identification will vary significantly depending on which elements of procurement are being examined. Variables will include:

- The time and effort required by the team;
- the range of knowledge and skills of participants;
- appropriate tools and techniques to facilitate information capture; and,
- knowledge of sources of procurement risks, from prior assignments.

Procurement activity of low complexity and value generally will not require an overly formal risk identification process. As the complexity of the procurement context increases, the procurement professionals alone will rarely have the full range of skills and perspectives required. End users, professional advisers with specialised skills and other stakeholders will assist, not only in getting a better understanding of the issues, but also through increasing the likelihood that the outcome will be understood, accepted and implemented.

Risk identification undertaken at the strategic level will generally require participants who have been engaged in the wider organisational planning process. The types of risks identified will be considerably different from those identified for an individual procurement activity. Similarly, risk identification for the procurement process will involve yet another mix of participants who will identify a set of risks. This is why it is important to disaggregate the procurement function before embarking on risk identification.

Separating risk identification for strategic procurement will facilitate engagement between procurement professionals and top management, in respect to the organisation’s strategic agenda and outsourcing decisions. This approach will ensure that senior management resource is strategically focused with specific procurement activity, and process partitioned for a different mix of management. It makes the risk identification relevant to the senior management’s role. Similarly the identification of risk at the procurement activity level will allow the focus to move from strategic to commercial aspects, where risk reduction both generally and within specific strategies such as outsourcing is undertaken.

As the procurement professional begins to engage with senior management in respect to strategic procurement and complex procurement activities, consideration should be given, particularly as organisations are embarking on the risk journey, to the use of risk management professionals. A risk management professional should be skilled in application of the risk process, engagement with senior management and facilitation of a risks identification and assessment.
In order to procure there must be a:

- **Buyer** – the organisation undertaking the procurement, including its internal environment of organisational roles, values, procedures and systems
- **Supplier(s)** – the organisation(s) supplying what is required, including its relevant supply chain and sub-contractors
- **Relationship** – the relationship between the buyer and its suppliers (including all its relevant legal, social and commercial dimensions whether or not they are set out in formal contracts); and
- **Environment** – the environment within which procurement takes place, including for example, its relevant social, political, economic, regulatory and physical dimensions (of which the physical infrastructure is an important part).

Setting aside the risks inherent in whatever is being procured, these are the key sources of procurement risk and are a convenient starting point for risk identification. It is necessary to also consider the interrelationship and interaction between the sources, as they are not independent of each other, as shown in the following diagram.

The following is a list of possible sources to consider when looking for risks that may diminish the effectiveness of procurement strategy in supporting the delivery of corporate objectives. It is to be used as a “thought starter” only and should be developed to satisfy the particular objectives of an organisation.

1. **Buyer**
   a. Clarity, consistency and understanding of corporate strategic direction.
   b. Relative importance of procurement needs and costs to organisational success.
   c. Organisational capability to understand markets and to manage procurement.

2. **Supplier**
   a. Future supply and demand for product.
   b. Capacity for Innovation and change.
   c. Market power and position.

3. **Relationship**
   a. Extent of complementary or competitive interest.
   b. Collaborative or adversarial culture.
   c. Potential for supply to be disrupted by the activities of other buyers and suppliers in this market.

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2 This elaborates on a diagram that originally appeared in Commonwealth Procurement Guideline 8, Managing Risk in Procurement, Australian Office for Better Buying (AGPS Canberra 1992)
4. Environment
   a. Economic conditions and cycles,
   b. Maturity of markets.
   c. Regulatory and compliance environments.

For procurement activities consideration should be given to identifying risks associated with:

1. Buyer
   a. Clarity of definition of requirements.
   b. Presentation and approach to market.
   c. Internal relationships and barriers to use particular suppliers.

2. Supplier
   a. Production process capacity & supply chains.
   b. Competing demands from different buyers.
   c. Commercial and financial capability.

3. Relationship, including:
   a. Contractual allocation of risks,
   b. Cultural fit and associated skill sets on both sides to manage the relationship
   c. Performance management arrangements

4. External Business Environment
   a. Fluctuations in currency, interest rates, and raw materials costs.
   b. Freight and logistics in respect to the physical and natural environment.
   c. Regulation & compliance

Risk Assessment

Risk assessment comprises the analysis and evaluation of identified risks. Analysis involves assessment against likelihood and impact. This is where an understanding of risk is developed, and circumstances that contribute towards the risk are considered. Risk assessment also includes the identification and evaluation of the effectiveness of existing controls.

Risk analysis may be qualitative, semi-quantitative, quantitative or a combination thereof, depending on the nature of the risks and the circumstances. These circumstances will include complexity of the risk, cost, time and the availability of reliable data.

Assessment of risk at the strategic level will generally involve qualitative techniques and may involve the use of evaluation criteria contained in a broader organisational risk framework where that exists.

Procurement activity risk should be against impact criteria that are a subset of the organisational evaluation criteria and take account of strategic procurement objectives. Criteria will generally be associated with cost, quality and predictable acceptability of supply. Depending on the type of procurement activity, it may be useful to consider semi-quantitative or quantitative risk analysis techniques.
The application of the same evaluation criteria for strategic procurement risk and procurement activities will rarely work, as one is about the broad organisational context and the other activities more specifically focused.

On completion of the risk analysis, an evaluation of the risks is conducted. The purpose is to make decisions on risk priorities and actions to be developed and implemented to manage risk to an acceptable level. It also needs to be acknowledged that in some instances it may not be possible to mitigate risk to an acceptable level. This will require decisions to be taken with regard to the future of the particular strategy or procurement activity.

On conclusion of the risk assessment, regardless of whether it is a strategic, activity or process risk assessment, or the level of sophistication applied, the same questions need to be answered:

- What are the risks?
- what risks are of concern (e.g. High, Significant, Medium and Low)?
- what do High, Significant, Medium and Low mean and how were they assessed?
- what is in place to manage those risks to an acceptable level of tolerance?

For those risks that are not being managed to a tolerable level there is only one question:

- What is being done to reduce the likelihood, or consequences or both?

**Risk Treatment in Procurement**

Risk treatments are the actions and processes put in place to reduce the likelihood and/or consequence of a risk. Risk treatment may include:

- Risk avoidance,
- risk transfer or sharing, e.g. through insurance, or by agreement between the involved parties,
- risk reduction by taking action to reduce the probability or consequences of an event.

Key procurement process elements such as identifying supply needs, specifying requirements, acquiring goods & services and ongoing management, are controls that assist with the management of risk. The effectiveness of these process elements will determine how well the identified risk is treated.

One of the key points in procurement risk management is to identify the extent to which an identified risk will be shared or allocated between buyer and supplier.

AS/NZS4360, in its definition of “risk sharing” has three additional notes:

- Legal or statutory requirements can limit, prohibit or mandate the sharing of some risks,
- risk sharing can be carried out through insurance or other agreements, (and),
- risk sharing can create new risks or modify an existing risk.
When considering whether to transfer or retain risk, consideration needs to be given to:

- Who will be accountable for the monitoring of the risk and what escalation processes are in place should the risk rating increase?,
- adequate control over the processes and activities that need to be implemented to treat the risk,
- alignment of risk tolerance, and
- who suffers the consequence?

The long established principle is that the party who is in the best position to control a risk should be allocated the responsibility to manage it. Although this principle has a basis in logic, it can, if misunderstood, contribute to a naive and somewhat immature view of risk.

Although risk and control may be transferred to the supplier, the consequence may be retained by the buyer or by other stakeholders, including customers. Similarly, a buyer may be in a position where the supplier(s) will bear the consequence of poor buyer risk management, resulting in additional cost factored into the supply.

In transferring risk and control consideration must also be given to legal and regulatory environments that may prevent the transfer of legal risk. It may be possible to agree through contract how consequence is apportioned, however this will be limited generally to financial losses. Consequences such as negative impact on reputation, criminal acts and statutory fines and penalties, cannot be transferred through contract.

For this reason, it is important to monitor the risk management practices of the supplier and any other party who may be involved in the treatment process. It is now common practice for suppliers and buyers to enquire into, monitor and audit the environmental and safety risk management frameworks of the other parties, but less so, for business and operational risks.

Where risk management has traditionally been internally focused, it is now time to consider a much closer relationship between parties where risk is discussed and managed. The mutual opening by suppliers and buyers of the risk identification and treatment plans in a consultative environment, will allow for a shared understanding of risk management, and more importantly, it will remove the assumption that just because a risk was transferred, the recipient is actually actively managing it.

### Risk Management – When is it applied?

The standard approach is to apply risk management at key stages in a procurement or project lifecycle. This approach is valid as it is at key stages that there may be material changes to the buyer/supplier, relationship or environment, resulting in the need to revisit the identified risks to determine if the treatment strategies are adequate, or new strategies may need to be developed.

The procurement professional must however, retain the sources of risk at “front of mind”. In some instances it may not be adequate to wait
until the next stage of the process to reconsider risk. Organisational objectives may change, suppliers may fail to perform or become insolvent, regulatory environments may become more onerous and relationships can weaken, all between defined milestones of the project.

At the strategic level, risk should be applied during the corporate and procurement planning cycle. This is necessary to ensure alignment of objectives is established, maintained and communicated.

**Risk Source Indicators**

Although it is important to monitor identified risks and treatments, it is critical to monitor the sources of risk. Change is often subtle; but there are usually indicators.

The procurement professional needs to use a suite of indicators that will assist with the detection of material changes to the risk source. Although organisations and industry will vary, activities that the professional should be undertaking are:

- Keep informed through the financial and business media.
- Maintain networks with other procurement professionals.
- Monitor indicators for key suppliers, including:
  - financial and non-financial KPI’s,
  - changes to strategic directions,
  - reports from rating agencies,
  - changes in key personnel Board and senior executives.
- Monitor changes to the external framework, including:
  - relevant legislative proposals through legal monitoring services,
  - Liaison with key stakeholder and industry groups.

**Risk Management in Australia – is it different?**

The answer is both “No” and “Yes”. On the one hand, the requirement to manage risk is the same everywhere. On the other, Australia can present very different problems. For example, when considering procurement risks unique to Australia it is logical initially to focus on the environmental issues such as remoteness, barriers to entry or market size. However there may be suppliers, buyers, and relationship risks that have not been identified. These may include cultural diversity, reliance on offshore supply and limited dominant brands and industries.
Role of Procurement Professional

The Procurement Professional should be an active participant in risk management seeking to ensure integration between procurement risk management and other relevant risk management activities, including enterprise risk management where that is in place.

Desirable key activities include:

- Developing and maintaining a procurement risk management framework which is integrated with the procurement process and wider organisational risk framework.
- Monitoring sources of procurement risk for material change that may impact on the organisation’s ability to achieve its objectives.
- Identifying tools and techniques that will assist with the identification and assessment of risk.
- Ensuring that the organisation’s procurement processes and methodologies are effective in treating identified risks.
- Clearly articulating the risks, in terms of uncertainty and severity when making procurement decisions.
- Actively participating in risk management discussion at both the strategic and operational levels.

Procurement professionals need to strongly articulate their analysis of the risks and consequences in the commercial language of senior management, and when the opportunity presents itself, lead the procurement risk dialogue of the organisation.

Conclusion

By integrating Procurement and Risk Management in their activities, procurement professionals and practitioners will be better positioned to engage with top management concerning their organisations’ strategic agenda and corporate governance. To add value to the CEO, this needs to be delivered through the clear articulation of procurement strategy and how it will support organisational outcomes.

In terms of specific procurement activities, a systematic approach where commercial risk is identified, assessed and managed to an acceptable level, will deliver bottom line benefits to the organisation. This will enhance the opportunity for procurement professionals to become more involved in major procurement projects and complex procurement decisions.

This approach may be limited by the maturity of risk management at the organisational level, providing the procurement professional with a challenge and an opportunity to take a leading role in contributing towards effective risk management across the enterprise.

Acknowledgements

The authors would like to thank Tony Butler MCIPS, Director Contract Services and Risk Management at the Department of Infrastructure and the mentor for this project. They also acknowledge Michael D’Aloia and Kate Hart of BHP Billiton, Grant Purdy and Dr Stephen Grey of Broadleaf Capital International PL and Karen Johnson, Department of Treasury and Finance, Victoria for their assistance and contribution to the paper.
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