

Procurement Risks & How to Mitigate Them



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Procurement risks refer to potential disruptions while acquiring goods or services.

These disruptions can stem from various sources, including supply chain interruptions, supplier failures, price volatility, geopolitical issues, and compliance problems.

The consequences of such disruptions often result in financial losses, delays in production, increased costs, and damage to an organization's reputation.

Risk Management in Procurement

Procurement risk management involves systematically identifying, assessing, and mitigating potential disruptions to ensure the smooth acquisition of goods and services.

Effective risk management aims to reduce the likelihood of procurement-associated risks and minimize their impact if they do occur.

Importance of a Strategic Risk Management Process

Strategic risk is a long-term risk that can affect the achievement of procurement goals.

It could emerge from market demand shifts, regulatory environment changes, or technological advancements.

Managing strategic risk is vital as it ensures that procurement aligns with the overall business strategy and adapts to future uncertainties, securing long-term success and competitiveness.

Common Procurement Risks and Their Assessment

Common Procurement Risks and Their Assessment



Supplier Risk



Market Risk



Operational Risk



Compliance Risk



Geopolitical Risk



Environmental Risk

▪ **Supplier Risk**

Supplier risk involves the potential for suppliers failing to deliver goods or services that meet agreed-upon specifications, timelines, or quality standards, such as product shortages.

Assessment Techniques:

- **Supplier Evaluation and Selection:** Conduct thorough due diligence during the supplier selection, including financial stability checks, past performance reviews, and facility audits.
- **Performance Monitoring:** Regularly monitor supplier performance using Key Performance Indicators (KPIs) such as on-time delivery rates, defect rates, and responsiveness.
- **Financial Health Monitoring:** Periodically assess suppliers' financial health by reviewing their financial statements and credit ratings.
- **Quality Audits:** Perform regular quality audits to ensure compliance with required standards and specifications.
- **Risk Scoring Models:** Use risk scoring models to quantify the risk levels associated with different suppliers and identify those requiring closer management.

▪ **Market Risk**

Market risk refers to the potential for adverse price fluctuations in raw materials, components, or finished goods, which can significantly impact procurement costs.

Assessment Techniques:

- **Market Analysis:** Conduct frequent market analyses to understand trends and price movements in key commodities and services.
- **Benchmarking:** Compare prices against benchmark data from

industry sources to identify anomalies or potential risks.

- **Trend Forecasting:** Utilize forecasting tools and techniques to predict future price movements and prepare for potential increases.
- **Sourcing Strategies:** Develop alternative sourcing strategies to switch suppliers or materials if market conditions dictate.
- **Contractual Adjustments:** Include contract clauses that allow for price adjustments based on market changes (e.g., escalation/de-escalation clauses).

▪ Operational Risk

Operational risk pertains to internal inefficiencies or errors within procurement processes that may lead to delays, increased costs, or supply disruptions.

Assessment Techniques:

- **Process Mapping:** Map out procurement processes to identify potential bottlenecks and inefficiencies.
- **Internal Audits:** Conduct audits of procurement processes to uncover weaknesses and areas for improvement.
- **Technology Integration:** Implement and continuously upgrade procurement software to streamline processes and reduce manual processes.
- **Training Programs:** Regularly train procurement staff on best practices and new technologies to ensure high competency levels.
- **Performance Metrics:** Establish and track performance metrics such as cycle times, order accuracy, and procurement costs.

▪ Compliance Risk

Compliance risk involves the possibility of violating legal or regulatory

requirements, which can result in legal penalties, fines, and reputational damage.

Assessment Techniques:

- **Regulatory Research:** Stay informed about relevant procurement regulations and standards through continuous research and subscription to regulatory updates.
- **Compliance Audits:** Perform regular compliance audits to ensure adherence to laws, regulations, and internal policies.
- **Policy Development:** Develop and enforce comprehensive procurement policies that align with regulatory requirements.
- **Training:** Educate procurement staff on compliance issues and the importance of adhering to regulations.
- **Third-Party Reviews:** Engage third-party experts to review compliance programs and provide recommendations for improvement.

▪ **Geopolitical Risk**

Geopolitical risk encompasses political instability, policy changes, trade restrictions, or other geopolitical events that can disrupt supply chains.

Assessment Techniques:

- **Geopolitical Monitoring:** Monitor geopolitical developments in regions with key suppliers using news sources, government advisories, and specialized geopolitical analysis services.
- **Supplier Diversification:** Diversify the supplier base across multiple geographic locations to reduce dependency on any single region.
- **Scenario Planning:** Develop and regularly update scenario plans for potential geopolitical events and their impact on procurement.

- **Risk Contingency Plans:** Create contingency plans that include alternative suppliers and logistical arrangements to adapt to geopolitical changes quickly.
- **Engage Political Risk Insurance:** To mitigate financial losses from geopolitical events, consider political risk insurance.

▪ Environmental Risk

Environmental risk involves natural disasters, climate change impacts, or other environmental issues that can disrupt supply chains.

Assessment Techniques:

- **Environmental Risk Assessments:** Conduct risk assessments to identify and evaluate environmental hazards that could affect the supply chain.
- **Supplier Resiliency Check:** Evaluate suppliers' resilience to environmental risks, including disaster recovery plans and infrastructure robustness.
- **Sustainable Procurement Practices:** Incorporate sustainable procurement practices to reduce exposure to environmental risks, such as sourcing from suppliers with strong environmental practices.
- **Supply Chain Visibility:** Enhance visibility across the supply chain to detect and respond to environmental disruptions quickly.
- **Emergency Preparedness Plans:** Develop and maintain emergency preparedness plans, including alternative supply routes and backup suppliers.

Balancing Cost Reduction and Risk

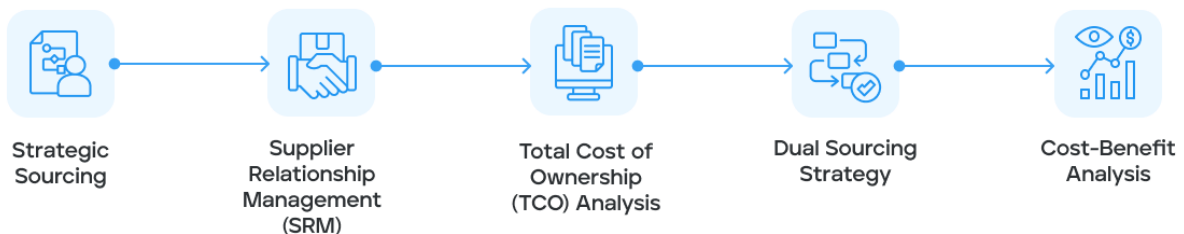
Management

Balancing cost reduction and risk management is a key challenge for procurement teams.

Organizations aim to minimize costs while ensuring their supply chain remains resilient to disruptions.

Achieving this balance requires strategic planning and various techniques to manage both objectives effectively.

■ Balancing Cost Reduction and Risk Management



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▪ Strategic Sourcing

Strategic sourcing involves developing a comprehensive procurement plan that aligns with the organization's overall business strategy.

It focuses on long-term partnerships with suppliers, value creation, and risk mitigation rather than just immediate cost savings.

Key Approaches:

- **Supplier Segmentation:** Classify suppliers based on their strategic importance and risk profile. High-risk or critical suppliers may require more rigorous risk management, while low-risk suppliers can be managed primarily for cost efficiency.
- **Total Cost of Ownership (TCO):** Evaluate the total cost of acquiring and using a product or service over its entire lifecycle,

including purchase price, maintenance, transportation, and disposal costs. This helps identify hidden costs to help your budgeting process and potential risks associated with cheaper options.

- **Category Management:** Strategically manage procurement categories (e.g., raw materials, services) by understanding market dynamics, supplier capabilities, and internal demand to make informed purchasing decisions.

▪ **Supplier Relationship Management (SRM)**

SRM is the systematic approach to managing an organization's interactions with suppliers.

It aims to maximize the value derived from supplier relationships through collaboration, communication, and continuous improvement.

Key Approaches:

- **Collaborative Partnerships:** Develop strong, collaborative relationships with key suppliers to ensure reliability and quality. Joint risk assessments and shared contingency planning can help mitigate risks.
- **Performance Metrics:** Implement performance metrics and regular reviews to monitor supplier performance. Address any issues promptly to maintain service levels and reduce risks.
- **Negotiation Leverage:** Use strong relationships to negotiate better terms, prices, and risk-sharing agreements. Suppliers may be more willing to accommodate requests if they see a long-term, mutually beneficial relationship.

▪ **Total Cost of Ownership (TCO) Analysis**

TCO analysis involves evaluating all the costs of procuring a product or service, not just the initial purchase price.

It includes direct and indirect costs such as transportation, storage, maintenance, and disposal.

Key Approaches:

- **Comprehensive Evaluation:** When making procurement decisions, consider all aspects of TCO. This helps avoid the pitfalls of selecting suppliers based solely on the lowest bid.
- **Risk-Adjusted Costing:** Factor potential risks and their financial implications into the TCO. For example, a slightly more expensive supplier that offers better reliability and lower risk may ultimately be more cost-effective.
- **Scenario Analysis:** Conduct scenario analysis to understand how changes in market conditions, supplier performance, or geopolitical events might impact TCO.

▪ **Dual Sourcing Strategy**

Dual sourcing involves procuring the same product or service from two or more suppliers.

This reduces dependency on a single supplier and mitigates the risk of supply chain disruptions.

Key Approaches:

- **Supplier Redundancy:** Maintain a backup supplier for critical products to ensure continuity if the primary supplier fails to deliver.
- **Geographical Diversification:** Source from suppliers in different geographic regions to mitigate risks associated with local disruptions (e.g., natural disasters, political instability).
- **Volume Allocation:** Strategically allocate procurement volumes between suppliers to maintain competition and leverage better pricing without overly relying on a single source.

• **Cost-Benefit Analysis**

Cost-benefit analysis evaluates the trade-offs between cost reduction and risk management to determine the optimal procurement strategy.

Key Approaches:

- **Quantitative Assessment:** Quantify the potential savings from cost reduction initiatives and compare them against the potential costs of associated risks.
- **Risk Weighting:** Assign weights to different risks based on their likelihood and impact. Use these weights to guide procurement decisions that effectively balance cost and risk.
- **Decision Models:** Develop decision models incorporating cost and risk factors to support more informed and balanced procurement choices.

Apple Inc. is known for its meticulous attention to balancing cost and risk in its supply chain.

The company diversifies its supplier base, sourcing components from multiple suppliers across different regions to mitigate risks.

For instance, Apple sources memory chips from various suppliers like Samsung and Micron.

This diversification helps Apple manage supply risks while negotiating competitive pricing.

Additionally, Apple invests heavily in supplier relationship management, including regular audits and performance evaluations, to ensure high standards and reliability.

Mitigation Strategies for Procurement

Risks

Mitigating procurement risks requires a comprehensive approach that combines proactive planning, strategic partnerships, and the use of technology.

Below are detailed strategies for addressing various types of procurement risks:

Mitigation Strategies for Procurement Risks



Diversification



Contracts and Service Level Agreements (SLAs)



Technology Integration



Continuous Improvement



Comprehensive Procurement Risk Management Plan



Supplier Development



Insurance

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• Diversification

Diversification involves spreading procurement across multiple suppliers and geographic regions to reduce dependency on any single source and mitigate risks associated with supplier failure or regional disruptions.

Key Approaches:

- **Multi-Sourcing:** Engage multiple suppliers for critical components or services. This ensures a backup in case one supplier faces issues.
- **Geographic Spread:** Source from suppliers in different countries or regions to protect against local disruptions such as natural disasters, political instability, or regulatory changes.
- **Supplier Tiers:** Develop a tiered supplier structure with primary

and secondary (backup) suppliers, ensuring continuity in case of primary supplier failure.

During the COVID-19 pandemic, companies with diversified supply chains were better able to manage disruptions.

For instance, Procter & Gamble's strategy of using multiple suppliers and production facilities worldwide helped them maintain product availability despite regional lockdowns.

• **Contracts and Service Level Agreements (SLAs)**

Contracts and SLAs are formal agreements defining the terms, conditions, and performance standards suppliers expect.

They provide legal recourse and clarity in case of disputes or non-compliance.

Key Approaches:

- **Detailed Contracts and Contract Management:** Draft comprehensive contracts that cover all aspects of procurement, including quality standards, delivery schedules, compliance requirements, and penalties for non-performance.
- **SLAs:** Include specific SLAs that outline performance metrics such as delivery times, defect rates, and response times. These help ensure accountability and performance consistency.
- **Risk Clauses:** Incorporate clauses that address potential risks, such as escalation provisions for price increases, force majeure clauses for unexpected events, and exit strategies in case of prolonged non-compliance.

Tech companies like Dell often include stringent SLAs in their contracts with component suppliers to ensure timely delivery and high-quality standards, reducing the risk of production delays.

• **Technology Integration**

Advanced technologies can enhance procurement processes' visibility, control, and efficiency, mitigating risks.

Key Approaches:

- **Supply Chain Management Software:** Implement software solutions that provide real-time visibility into the supply chain, enabling better tracking and management of procurement activities.
- **Automation:** Use automation tools to streamline routine procurement tasks throughout the procure-to-pay cycle, like purchase orders and approval workflows, reduce human error and data entry, and improve process efficiency.
- **Data Analytics:** Employ data analytics to gain insights into supplier performance, market trends, and potential risks, allowing for informed decision-making.
- **Blockchain:** Consider blockchain technology to enhance transparency and traceability in the supply chain, reducing risks related to fraud and compliance.

Walmart uses blockchain technology to track the provenance of fresh produce from farm to store, enhancing food safety and reducing risks associated with contamination and recalls.

• **Continuous Improvement**

Continuous improvement involves regularly reviewing and refining procurement processes to address emerging risks and enhance overall efficiency and effectiveness.

Key Approaches:

- **Kaizen:** Adopt the Kaizen philosophy of continuous incremental improvements by involving all employees in identifying and solving procurement-related issues.

- **Regular Audits:** Conduct regular internal and external audits of procurement processes to identify weaknesses and areas for improvement.
- **Feedback Loops:** Establish feedback mechanisms with suppliers and internal stakeholders to continuously gather input and make necessary adjustments.
- **Benchmarking:** Compare procurement practices against industry best practices to identify gaps and implement improvements.

Toyota's implementation of the Kaizen philosophy in its supply chain management has led to continuous improvements in efficiency, quality, and risk mitigation, contributing to its reputation for operational excellence.

▪ **Supplier Development**

Supplier development involves working closely with suppliers to improve their capabilities, reliability, and overall performance.

Key Approaches:

- **Training Programs:** To enhance suppliers' performance, offer training programs on quality management, compliance, and best practices.
- **Joint Improvement Initiatives:** Collaborate with suppliers on joint improvement projects, such as process optimization or technology upgrades.
- **Incentives:** Provide incentives for suppliers to meet or exceed performance standards, such as long-term contracts or financial bonuses.
- **Capacity Building:** Assist suppliers in building capacity to handle larger volumes or more complex orders, reducing the risk of bottlenecks.

General Motors invests in supplier development programs to improve the capabilities of its suppliers, ensuring consistent quality and reliability in the supply chain.

▪ **Insurance**

Insurance provides financial protection against specific risks, helping mitigate unforeseen events' impact on the procurement process.

Key Approaches:

- **Political Risk Insurance:** Obtain insurance to cover losses arising from political events such as expropriation, currency inconvertibility, or civil unrest.
- **Business Interruption Insurance:** Secure insurance that compensates for lost income and additional expenses if a disruption halts operations.
- **Product Liability Insurance:** Cover risks associated with defects or failures in supplied products that could lead to legal claims or financial losses.
- **Natural Disaster Insurance:** Protect against losses from natural disasters like earthquakes, floods, or hurricanes that could disrupt supply chains.

Airbus uses political risk insurance to protect its investments and supply chain operations in regions prone to political instability, ensuring minimal financial impact in case of disruptions.

▪ **Comprehensive Procurement Risk Management Plan**

A comprehensive procurement risk management plan incorporates all the above strategies into a cohesive approach, ensuring that risks are identified, assessed, mitigated, and monitored effectively.

Key Components:

- **Risk Identification:** Catalog potential risks through supplier assessments, market analysis, and historical data review.
- **Risk Assessment:** Evaluate the likelihood and impact of each risk using quantitative and qualitative methods.
- **Risk Mitigation Strategies:** Develop and implement strategies tailored to address specific risks, such as diversification, contracts, and technology integration.
- **Monitoring and Review:** Continuously monitor risks and review the effectiveness of mitigation strategies, making necessary adjustments based on changing conditions.

Boeing's comprehensive risk management plan includes supplier diversification, rigorous quality controls, technology integration, and continuous improvement initiatives.

During the 737 MAX crisis, Boeing's ability to quickly adapt and manage its supply chain risks minimized disruptions and facilitated a faster path to recovery.

Protect Your Company and Profitability

Organizations can safeguard their supply chains by understanding and addressing these procurement risks through detailed assessments and strategic mitigation measures, ensuring business continuity and financial stability even in unexpected disruptions.

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