

# Bringing Rigor to Risk Management

***Risk management takes on a challenging new dimension in today's extended supply chains. Meeting that challenge begins with a robust planning process.***

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Risk management is emerging as a key focus area for corporations, especially in terms of the extended supply chain. Traditionally, commodity-price fluctuations and supply disruption have

been the two top-of-mind risk concerns for supply management people. But as they take on expanded responsibilities for global sourcing, these professionals are also increasingly required to manage risk in terms of brand, reputation, and ethical sourcing.

Recent corporate history shows a number of instances in which companies have suffered heavy losses because they failed to manage global risk effectively. For example, Sony recently lost more than \$420 million from the recall of millions of lithium-ion battery packs that it manufactured or assembled in China and sold for use in computer equipment by companies like Dell, Apple, and Toshiba.

While awareness of the need for risk management continues to rise, few companies feel confident in their ability to work it into the corporate skill set, especially when it comes to monitoring risks. Yet as companies look to expand their global footprint, supply risk is emerging as a concern for the entire executive suite, not just the procurement or supply management chief.

## Efficiencies Introduce Risk

Corporate concern about global risk exposure stemming from the extended supply chain is warranted, especially considering that the supply chain efficiencies in place today can potentially introduce or heighten supply-related risk. By outsourcing manu-

facturing, for example, companies expose themselves to the potential theft of their trade secrets. And while just-in-time manufacturing and streamlined order-fulfillment techniques may reduce inventory, they also multiply the negative consequences of supply chain disruptions. Acquisitions introduce complexity by bringing on new suppliers that were selected through unknown evaluation criteria as well as new assets that introduce risk. Supply consolidation, another proven efficiency, can create choke points or bottlenecks in the supply chain. Even a seemingly safe strategy like organic growth can potentially stress assets and suppliers to the breaking point.

Supply risks can have a significant impact on business results, including lost revenue, increased cost, lost assets, and decreased market value. While supply management professionals commonly acknowledge such concerns as supply continuity disruption and price volatility, they also need to be aware of other issues not traditionally associated with procurement. Quality and safety, for instance, can be compromised when supply fails to meet agreed-upon standards. Brand value can be tarnished by association with suppliers that behave in a manner that is inconsistent with your corporate values. Intellectual property theft can occur when companies enter into contract research or contract manufacturing arrangements.

Despite the scope and nature of the threats, A.T. Kearney research shows that the majority of companies are still in the planning phase when it comes to supply risk management. And in some cases, even the most basic operational planning has yet to be done, which only magnifies the impact when a crisis occurs. Only where the supply base is core to the business model or recognized as a key value driver does risk management become a specific point of

emphasis in corporate initiatives.

No risk mitigation strategy can succeed without a common vocabulary that is understood and used both within the company and with external partners. Risk consists of the measurable possibility of losing or not gaining value. Risk exposure is the quantified measure of risk for any single event as calculated by multiplying the impact of such an event by its probability. Risk profile represents an organization's or entity's collective risk exposure. Risks, in turn, fall into three distinct categories: (1) event risks, which occur at single point in time and have a significant impact on a company; (2) market risks, which refer to volatility in traded markets, be they commodities or currencies; and (3) strategic risks, those longer-term trends that will have an impact over a period of time.

**Cost-Benefit Trade-offs**

A rigorous risk management program encompasses three key elements: risk characterization and prioritization, segment-level risk planning, and implementation and tracking.

Each company, business unit, and/or function needs to prioritize risks by calculating its risk exposure to determine where the greatest threats lie. Without a quantified understanding of the cost-benefit trade-off around each risk, the organization cannot make a well-informed decision. The first instinct may be to undertake supply risk planning on a category-by-category basis. However, the planning process can be made more efficient by undertaking a portfolio-centric search around commonalities such as common raw materials or a common geography. Exhibit 1 shows a sample framework for analyzing risks.

Detailed risk planning also requires an evaluation of the cost-benefit trade-off of both proactive and reactive risk management approaches. These high-level methods include seven potential approaches to each risk:

1. **Avoid:** Proactive action that eliminates the possibility of an event.
2. **Transfer:** Proactive action (often financial or legal) that shifts risks to a third party.
3. **Mitigate:** Proactive action that reduces the financial impact if an event occurs.
4. **Minimize:** Proactive action that reduces the probability of an event occurring.
5. **Respond:** Predetermined actions taken after an event occurs in order to reduce the impact.
6. **Monitor:** Continuous scanning of the environment that triggers alternative actions or the implementation of certain measures

if predefined thresholds are exceeded.

7. **Accept:** Decision to bear risk exposure without taking any additional actions.

Although risk management is not yet part of the culture at all companies, some initial best practices are emerging. One is to centralize the risk management process while decentralizing the actual decision making, which allows supply owners to apply their deep knowledge of circumstances around the risk. The leaders also are developing their own comprehensive, creative risk management solutions, as no one single method—or even handful of methods—will suffice. Perhaps most importantly, they emphasize the upside to risk analysis, recognizing that the situation is not all gloom and doom.

**Reaping the Rewards**

Conceivably, those companies that come to excel at managing risk will be able to turn this competency into a competitive differentiator. For example, if a natural disaster or political instability cuts off the flow of key goods or materials from a geographic area, those companies that maintain alternate sources of supply will still be able to bring their merchandise to market. Their sole-source competitors, by contrast, will be left to scramble for a new base of supply.

Ultimately, business units and corporate functions cannot successfully manage risk by themselves; executive sponsorship is key to developing a corporate-wide risk mentality. Some of the leaders, in fact, have established the role of chief risk officer.

For companies not that far along, the key is to build momentum for their efforts by clearly demonstrating that risk management represents an opportunity rather than just a cost. And that opportunity will come to those who plan.

