

5 Insights for executives

Of special interest to

Chief financial officers

Chief operating officers

Chief procurement officers/VPs

Chief supply chain officers/VPs

Don't let your supplier take you down!

Five steps to address procurement risk

Jim G. thought he had done his homework. The VP of Supply Chain had counted on Jim, a senior procurement executive, to solve a serious supply issue that had threatened to derail production of one of his company's best-selling products. When he found a supplier that could guarantee an uninterrupted supply of coltan, a metal ore from which tantalum could be extracted and used in their cell phones, he leapt at the opportunity.

Jim asked several questions related to the ore's origin. However, he failed to include a clause in the contract obligating the supplier to report any sourcing of the mineral from conflict countries. Jim was also unaware that to keep the supply of coltan flowing, his supplier had bribed a few officials along the way.

Now, both the SEC and the U.S. Department of Justice (DOJ) were investigating Jim's company as well as the Chief Operating Officer (COO) and him personally for Dodd-Frank and Foreign Corruption Practices Act (FCPA) violations. If they were found guilty, the company would face fines in the tens of millions. More significantly, there was a possibility that he and his boss could go to jail because of the bribes his supplier was doling out on their behalf.

Jim was in a state of despair. He had no idea the kinds of procurement risks he faced when he sought to secure a continuous supply of coltan. And now his career was in jeopardy.

1

What's the issue?

In a post-financial-crisis world, transparency has become a top-of-mind issue for organizations doing business in both developed and developing countries. Procurement is being asked to play an increasing role in addressing new legal and regulatory guidelines that facilitate transparency. However, even though procurement organizations are responsible for managing suppliers and their inherent risks, many are ill-equipped to mitigate those risks.

All US organizations are subject to FCPA compliance, but there are several other risk types that procurement organizations can be exposed to. These include:

Risk types	Examples
Execution	<ul style="list-style-type: none">▶ Late deliveries▶ Lacking capabilities▶ Non-compliance to service level agreements (SLAs)
Commercial	<ul style="list-style-type: none">▶ Overpayments▶ Duplicate payments▶ Non-compliance to terms
Operational	<ul style="list-style-type: none">▶ Health safety and environmental non-compliance▶ Inability to supply
Competitive	<ul style="list-style-type: none">▶ Loss of intellectual property▶ Damage to reputation▶ Sustainability
Regulatory	<ul style="list-style-type: none">▶ FCPA/UK Bribery Act▶ Labor laws▶ Sanctions▶ Domestic government regulations▶ Withholding tax

To truly address the risk landscape, procurement needs to understand the customer service, operational, financial, technology, and business and ethical practices of all the suppliers with whom the organization does business globally.

This means having a deep understanding of how suppliers do business, such as whether they operate in countries where bribery is a pervasive business practice or whether their manufacturing capabilities are suddenly changing. Reducing supplier risk can reduce fraud, drive competitive advantage and optimize corporate profits.

Governments around the world are stepping up both regulations and enforcement of violations relating to supplier risk.

2

Why now?

Several recent events have demonstrated how procurement risk can disrupt operations, impact financials, erode competitive position and goodwill, or create compliance issues with significant penalties:

- ▶ A large multinational oil company suffered huge financial and brand damage following an explosion on one of its oil rigs. Although the company owned the asset, it had contracted with one or more suppliers to operate and maintain it. In addition to loss of several lives, the environmental damage and the damage to people's livelihood and property in the surrounding area have spawned several lawsuits. As in-depth investigations and the courts continue to sort out where the blame lies for the incident, the oil company has had to divest billions of dollars in assets to address the financial consequences.
- ▶ A 9.0 magnitude earthquake and subsequent tsunami in Japan in 2011 disrupted the global supply chains of a number of automotive manufacturers, causing parts shortages that delayed order-to-delivery times.
- ▶ Flooding in Thailand affected supplier manufacturing for a global technology company. When news broke that the factories could be closed for several weeks, the technology company's stock was negatively affected.
- ▶ In 2010, the DOJ assessed \$1.8 billion in fines and prosecuted close to 50 entities and individuals for FCPA violations. The UK Bribery Act, enacted in 2011, applies to UK and foreign companies doing business in the UK and includes unlimited fines and up to 10 years in prison.
- ▶ The Dodd-Frank Act of 2010 may require (pending potential litigation) companies to report annually on whether they are using minerals from conflict countries and report on the due diligence they have undertaken to verify tainted metals in their supply chain.

Governments around the world are stepping up both regulations and enforcement of violations relating to supplier risk. As cost pressures mount, margins are squeezed and industry competition intensifies, now is the time to take a proactive approach to managing the risk and prevent supply chain issues from occurring.

3

How does it affect you?

Many procurement risk strategies that organizations implement are still too reactive, responding to events that have already occurred rather than seeking to prevent them from happening in the first place.

An effective procurement risk management program can help organizations proactively manage risk profiles, providing increased levels of transparency and visibility into the procurement process.

By being able to prevent negative outcomes from occurring, and properly plan for force majeure events, procurement executives can improve business performance and save the organization from costly financial penalties, brand damage, share-price erosion and competitive disadvantage.

4

What's the fix?

Here are five steps procurement can take to better manage risk.

1. Assess the risk landscape. This should include tiered assessments that establish likelihood and impact criteria to focus efforts. You will also want to develop risk mitigation strategies for each risk grouping and a procurement risk governance model that establishes roles and responsibilities.

2. Deploy comprehensive supplier reviews. This should include a process for periodically reviewing existing suppliers and a verification process to qualify new suppliers. Standard terms and conditions may need to be modified in order to support the risk mitigation strategies.

3. Optimize procurement risk management (PRM) controls. Ensure that both detect controls (e.g., audits) and prevent controls (e.g., requisition review) support the risk mitigation strategy. Responsibility should be clearly assigned within your organization with executive support.

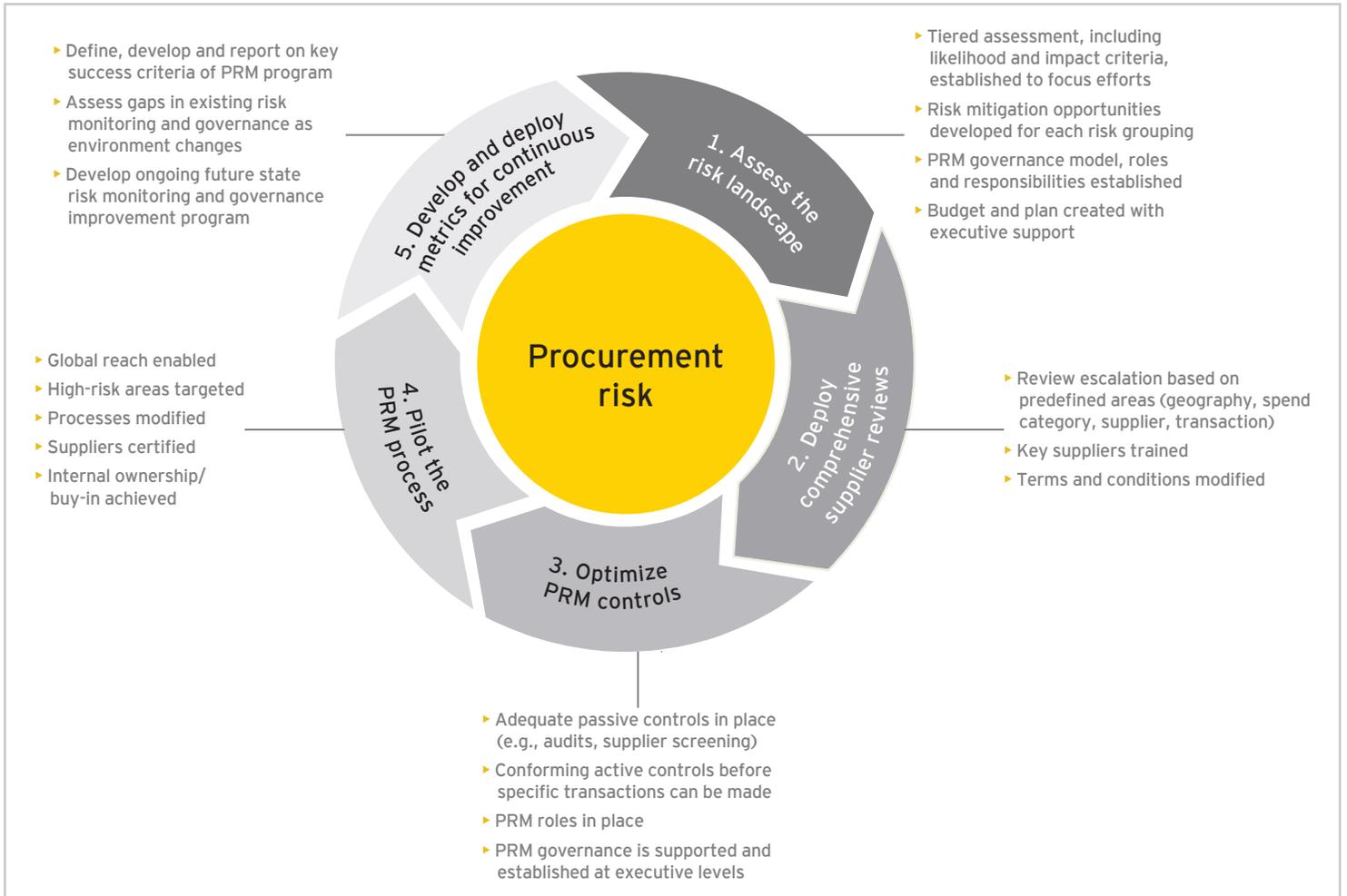
4. Pilot the PRM process. The pilot should determine that global reach is enabled, high-risk areas have been targeted, suppliers are certified and that processes are modified where necessary.

5. Develop and deploy metrics for ongoing measurement and continuous improvement. Once your procurement risk management program is up and running, you will want to establish metrics for ongoing improvement. Assess and close the gaps in current risk monitoring and governance, and develop future state risk monitoring to ensure the program evolves with the business.

In addition to these five steps, you may wish to consider technology tools that can help to better manage risk areas. In particular, access to real-time information, such as production data, news feeds and notifications of investigation, can help the procurement function properly respond to risk triggers to proactively manage risk. This type of "risk dashboard" may also help manage supplier and employee compliance with PRM strategies before they become liabilities.

Procurement risk is a moving target. Investments should be proportionate to the associated impact and likelihood of occurrence for the most relevant types of procurement risk to your organization.

Five steps to managing procurement risk



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5

What's the bottom line?

Current and emerging regulations, as well as the increasingly global reach of supply chains, require organizations to proactively approach procurement risk management in a way that enables them to effectively and efficiently manage supplier risk.

The alternative could be disastrous. The risks of not knowing the business practices and potential liabilities of your suppliers could not only lead to financial penalties and brand damage. It could put you out of business.

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You can contact us at:
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