Use Gartner’s Optimum Risk Utilization Framework to Drive Competitiveness and Improve Agility in Procurement

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CPOs face uncertainty, often with a narrow view of risk and rarely as a lever for upside opportunities to create competitive advantage. This research refocuses the risk definition in a practical framework and introduces optimum risk utilization as a catalyst for success through sourcing.

Key Challenges

- Risk management commonly emphasizes the process of mitigation reflecting limitations, additional tasks and audits that adversely impact the value, complexity and velocity of sourcing processes and operations.
- Chief procurement officers (CPOs) prioritize business continuity over agility in the risk appetite statement by focusing on risk mitigation rather than risk utilization as the incubator of innovations.
- The misconception of risk formalized in a risk appetite statement limits sourcing’s ability to thrive in uncertainty and leverage imbalances to support and advance the business strategy. Over time, this approach decreases competitiveness with fading competencies.

Recommendations

CPOs responsible for direct material sourcing who are enabling core competencies and competitiveness should:

- Analyze and define the optimum risk utilization applicable to sourcing activities to drive the business strategy forward within the underlying industries, and develop and formalize a sourcing risk appetite statement.
- Build a lean and effective cross-functional governance framework to serve as a risk oversight and advisory function with the key mission to support risk-based decision making.
- Use the integrated risk model to create a bimodal optimized risk utilization sourcing strategy with value-add sourcing plans supported by enhancements in people, processes and tools.
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Introduction

Sustainable competitiveness enhanced by current and new core competencies is a key performance criterion for increasing market share, profitability and value creation. Other key success indicators, such as cost savings and working capital improvements, pivot from this economic logic and are consistently part of a CPO’s target agenda.

While these criteria are established variables of value generation, nowadays, risk is often interpreted as a subtraction to that equation or as “the probability of an unwanted outcome happening.”\(^1\) However, risk in the classical view is the variable expressing the “imperfect knowledge of the future, a consequence of change, not change as such.”\(^2\) Therefore, initially, risk is neutral but measurable as the likelihood that the outcome deviates from the target,\(^3\) and can be positive as added value or negative as a shortfall. In other words, CPOs need to recognize that risk can have negative or positive consequences. This expanded view opens up new opportunities. This understanding is fundamental to drive risk utilization initiatives that ensure more benefit than negative impact or organizational burden. The analysis will explain in depth the concepts and provide a practical guide for the application of risk optimization initiatives. Figure 1 summarizes the extended classical view and the more common application of a narrow risk view.
Analysis

Define the Optimum Risk Utilization for Sourcing to Advance the Business Strategy

Understand, Communicate and Champion the Shift in the Risk Paradigm

Definitions of risk in literature and in practice vary in scope, type and perception. For example, ISO 73:2009 alone lists five variations. With this background, organizational risk management frameworks often consider solely risk reduction and mitigation, which are supported by position papers of supply management institutions’ other subject matter publications’ limiting the risk definition to the downside potential.
Based on this setup, the highest likelihood is given to reaching the targeted outcome, not better or worse, which is driven by the bias that targets are usually set to be achievable within the existing confines of abilities. The journey to the target is reinforced by a risk mitigation framework focusing on incident discovery and tools to mitigate the impact. These include lean recuperation models like the eight disciplines of problem solving (8Ds) methodology, or failure mode and effects analysis (FMEA). Various lines of defenses are built around a risk mitigation framework, commonly following the three lines of defense model. The lines represent the one owning and managing the risk, the one overseeing the risk, and the one providing independent assurance.  

This, however, creates an increased burden of bureaucracy, and impacts organizational agility and ability to act and, worse, react in a timely manner. The organization starts to impede its own success by slowing down and limiting its attention to itself — a clear paradox to the intent of risk management.

This background is important to understand before looking further into risk as a lever in uncertainty. The narrow risk view represents the root cause that risk has been disregarded as a positive driver in the value chain and part of the toolbox in sourcing.

CPOs need to see risk as a neutral indicator of likelihood of deviation, positive or negative. With that view, the potential of upside opportunity opens up and becomes part of the strategy and operations. This is the required fundamental shift in the definition. The value proposition is elevated beyond the limitation of the bias of an achievable targeted outcome. It is emphasized in Figure 1 as the risk utilization section. There, the realized outcome provides added value beyond the targeted outcome, which could come in tangible and intangible benefits such as cost savings, faster time to market and first access to innovation. As long as those are greater than the associated cost or effort it took to realize them, the results will drive increased competitiveness and agility. The impact will be even larger and provide a significant advantage over the competition once this happens across a number of sourcing engagements and projects. Implementation of this concept provides a perfect opportunity for procurement leaders to drive the business strategy forward.

The underlying principle is that “no valid measurement of the value of risk can be given without consideration of its utility, that is the utility of whatever gain accrues to the individual.” Hence, the value creation should incorporate added value as well as risk mitigation, not by chance but by conscious, risk-based decision making.

**Develop and Formalize the Sourcing Risk Appetite Statement**

With the new risk paradigm as the baseline, the next step is to develop and formalize the risk appetite statement as the guardrail for success. This is fundamental and imperative for this transformation, and sets the boundaries on the willingness to explore the optimum risk utilization.
The risk appetite definition will detail to what extent exposure should be assumed to achieve strategic and operational goals, sustain competitiveness, and increase agility.

To develop the risk appetite, start by creating the risk profile and quantifying the risk capacity. This will be a qualitative and quantitative current-state risk analysis. The risk profile is mainly based on external factors, whereas the risk capacity is an internal focus based on the strengths and unique competencies in sourcing.

Begin with the risk profile, which is established based on the assessment of supply markets, taking into consideration supply market maturity, competition, dependencies, disruptions, regulations, and other applicable macro and micro economic factors. For more established sourcing functions, a common approach that can facilitate the initial effort is to start with the existing segmented supply categories and strategies. Then, perform a deep dive into the supply market analysis, such as with Porter’s Five Forces or Six Forces enhanced model.

This is complemented with the risk capacity analysis which is the ability to gather and process information, to run predictive analytics and simulations on financial strength, human capital scenarios and other internal competencies related to maturity of the sourcing function.

This analysis will provide the input to assess the required effort and risk assumption to yield the targeted outcome. It will also provide transparency for the existing ability and capacity, financially and operationally, to absorb any potential shortfall caused by increased uncertainty and exposure to realize added values.

As a result of this exercise, the CPO can formalize a clear, comprehensive and concise risk appetite statement to complement the sourcing strategy. This statement will facilitate communication and adoption while reducing ambiguity. Examples for the risk appetite statement to consider are adjusted guidelines to be applied in certain situations in regard to ROI, net present value (NPV), and other financial governance and compliance requirements for capital asset purchases or ramp-up/tooling investments. Other examples include exceptions to policies and other requirements to apply to new engagements and projects, depending on the enhanced five Ws of information gathering — who, what, when, where, why and how.

Figure 2 shows the process to formulate the sourcing risk appetite statement, from an individual analysis to the aggregated outcome. Companies typically operate within the boundaries of risk capacity and the overall supply risk profile (the lower-left quadrant). Without any adjustment, the utilization of the risk appetite should include the markets with a higher supply risk profile, as long as the risk capacity can absorb any shortfalls. This is represented in the leverage and explore area of the figure. The red zone represents any engagement and activity beyond the tolerance of the present risk capacity and should be clearly mentioned as prohibitive in the risk appetite statement.
From the moment the risk appetite statement is released, it sets boundaries that will need to be reassessed as the company is exposed to more changes. In the model in Figure 1, it has the potential to reset the targeted outcome bias and to be the catalyst for adopting the broader risk framework. This exercise needs to be repeated periodically to adjust the risk appetite statement, responding to changes in the supply risk capacity or the supply risk profile. Every shift and development yielding material changes in the markets, competition, disruptions and economic factors, and internal and external culture, systems, tools, and regulations must be followed up with an evaluation of the risk appetite accuracy and relevancy.

The organization should not see the risk appetite statement as finite but as an ever-changing, continuous process for maximizing results.

Build Cross-Functional Governance to Serve as a Risk Oversight and Advisory Function to Support Risk-Based Decision Making

In addition to developing the risk appetite statement and in support of driving a risk-reward culture, the next step is to form an oversight and advisory council. The council should include leaders from key areas such as strategy, finance, legal, research and development, quality, manufacturing, and supply chain operations. The group is led and chaired by the CPO to ensure that the group focuses on its purpose to support value-add activities and does not become an internal audit and revision function (see Figure 3). This is crucial to provide independent and comprehensive support to the assessments of supply risk profile and supply risk capacity indicator changes driving enhancements.
in both areas. Adjustments to the sourcing risk appetite should be discussed with the sourcing risk oversight and advisory council as well as any exploratory risk expansions that would require additional short-term risk capacity adjustments, such as capital reallocation to support these activities. This is also the forum to discuss and evaluate in advance of any changes in requirements, regulations and other indicators that might impact the sourcing strategy. Lastly, any sourcing successes and failures should be shared and communicated in this forum judgment-free to optimize risk utilization to add value. The CPO and all participating leaders need to keep this judgement-free zone at the core of any discussions and evaluations. The council represents a forum to align targets and nurture the culture of risk utilization across functions, and weigh trade-offs with risk-reward in mind.

Figure 3. Cross-Functional Sourcing Risk Oversight and Advisory Council Structure
Utilize the Integrated Risk Model to Create a Bimodal Optimized Risk Utilization Sourcing Strategy

As shown, the new risk paradigm and the risk appetite statement with its governance structure are the prerequisites for an integrated risk management model to drive value. This model will enable the organization to explore and leverage untapped opportunities. It will effectively lower the risk exposure while establishing a smoother risk curve, enhancing its risk capacity (see the orange dotted curve in Figure 4).

Figure 4. The Integrated Risk Model and Fundamental Support Streams

Figure 4 shows the most developed stage of the integrated risk model, which serves as the blueprint for organizations to transform. Large and mature organizations usually have the resources to support the capital-intensive investments necessary for talented people, cutting-edge technologies, advanced processes and sophisticated tools. Startups and immature companies, while using the enhanced integrated risk model early on, may not have the resources to lower the risk exposure. Therefore, the negative impact probability and volatility of success is higher.

Large companies that deviate from an uncontrolled startup risk model to a narrow risk management focus usually have established systems, proven risk mitigation tools and highly trained human...
capital to engage in a transformation to the integrated risk model. Nevertheless, significant changes to all aspects of strategy and operations, in addition to careful change management and executive involvement, are required. A bimodal approach is recommended to explore the boundaries of the supply risk capacity. This can be supported by the sourcing risk oversight and advisory council with a short-term expansion of risk capacity. The expansion could include additional funding, exceptions to insurance requirements and certifications, which will help facilitate engagements, or mitigate and contain any shortfalls during the risk utilization activities. These activities range from asymmetric partnerships and untapped supply markets integration, to joint development and manufacturing efforts utilizing heavily advanced levers across key support streams.

A pilot implementation directed at high-risk, high-reward initiatives can quickly provide successes and become a significant catalyst to further progress and enhance the supply risk capacity.

Examples of key levers per support stream (i.e., people, processes and tools) for risk mitigation and risk utilization are listed in Figure 4.

Initially, the CPO should drive initiatives to assess the state of core risk management capabilities. Risk mitigation aims to provide a resilient infrastructure and governance. Value leakage prevention and negative impact avoidance are priorities supported by containment skills based on standard reaction and business continuity plans. These should be established before starting to explore, develop and deploy risk utilization capabilities.

In addition, and distinct to risk mitigation, risk utilization championed by the CPO nurtures a culture that is motivated to:

- Constantly innovate to disrupt by trial and error
- Implement flexible processes
- Accommodate instant morphing with influx data integration
- Create predictive simulation abilities
- Use refined tools such as game theory

Appropriate performance management and staff empowerment are critical, otherwise the risk mitigation attitude can prevail. Eventually this results in establishing a highly competitive organizational agility, backed by a sophisticated level of digitalization and a 360-degree approach to gather, analyze and use information for the best outcome in risk-based decision making. This will culminate in a maximized supply risk capacity.

The expectation is that, with the optimum risk utilization and integrated risk model application, a high-risk and high-reward opportunity will become a low-risk and high-reward scenario for
companies that have evolved to this. An extremely powerful, yet often underutilized, competency will be developed in comparison to competitors if implemented controlled and fearlessly.

**Bottom Line: The Unique Opportunity to Make a Difference**

CPOs are well-positioned to leverage the integrated risk model, establishing an augmented sourcing function delivering results above expectations, lowering the risk exposure and providing cross-benefits in support of the broader business strategy. This will position the enterprise favorably in its markets and industries as a core player with which innovative and disruptive companies would like to engage. Since the burden of asymmetric partnership is reduced through an agile and adaptive sourcing organization, untapped innovations and key external competencies are now able to come into the organization across all engagements, enhancing its competitiveness.

For sourcing, this will drive a stronger linkage to stakeholders and boost, through its initiatives, the business strategy success. Sourcing will truly become a business partner and strategy shaper with a clear purpose and a reserved seat for the CPO in the C-suite, right next to the CEO.

**Gartner Recommended Reading**

*Some documents may not be available as part of your current Gartner subscription.*

- “How to Get Your CEO to Embrace Digital Risk Management”
- “Top 10 Factors for Integrated Risk Management Success”
- “Ignition Guide to Drafting Information Risk Appetite Statements”

**Evidence**


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