Managing third party expenditure

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Other management handbooks published by Collinson Grant:

- Managing indirect costs – June 2010
- Managing productivity – July 2011
- Managing restructuring - November 2012
- Managing organisational design – March 2015
- Employment law for line managers – revised and published annually

Copies of these and other documents are available on request.

Getting best value for money for our clients has been at the heart of what Collinson Grant does since the early 1980s. Sometimes the effective management and control of third party expenditure can be neglected by senior managers despite its immediate impact on profitability. Our work as management consultants focuses on costs, organisation and people. We use this simple framework to manage complex assignments – often with an international dimension – and to support managers on smaller, more focused projects. Supporting clients in responding to changed circumstances, in seizing opportunities and in strengthening their businesses is a constant feature of our work. The notes at the back summarise what we do.

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Contents

Introduction

This book should help those in leadership roles who are responsible for managing third party expenditure. This is often one of the most challenging roles in any organisation, because while the leader may have responsibility for the expenditure, they do not have absolute control over the supplier (by contrast with internal activities).

The ever-increasing complexity of our business environment, and the growth of digital and global supply chains demand an unprecedented level of skill in managing third party expenditure. This conflation is complicated further by the fact that almost everyone has been or goes shopping, and therefore believes they are experts in knowing how to buy things.

Successful enterprises recognise both the opportunities and risks in their supply markets. While procurement teams should take advantage of potential opportunities to reduce total cost and achieve better value for money, they are also expected to manage and minimise the potential risk emanating from the supply chain. The most adept organisations deal with both the strategic and tactical aspects of managing third party expenditure and have right balance between driving value and minimising risk. In addition, they focus on the continuous improvement of their people and the technology used to understand and manage their supply chains.

Beyond this, managers of third party expenditure must consider corporate social responsibility and reducing reputational risk. They must recognise the integrity of their brand and the potential risk of brand dilution arising from even the slightest doubt about their business practices. Whereas ethical sourcing may once have been considered a ‘nice to have’, the expectation of sound business ethics is a ‘given’ today.

The merits and demerits of different models of organisational design for managing third party expenditure continue to be espoused. No one size fits all.

This books aims:

- to set out principles for managing third party expenditure

- to show how elements of a strategy for this can be defined
- to emphasise the importance of understanding third party expenditure and its cost drivers, as well as to introduce some techniques for enhancing such understanding
- to assess the potential trade-offs in optimising an organisation's supply chain
- to explain the two main processes of third party expenditure management, namely strategic sourcing and transactional procurement
- to highlight the importance of an effective governance framework and compliance management for an organisation's purchasing activities
- to discuss the impact of evolving technologies
- to consider different models of organisational design
- to outline the attributes of a great procurement professional.

Collinson Grant has helped many organisations to manage their third party expenditure. Our approach is based on practical insights gained from our experience of working with our clients during the past forty-five years. It is aimed not only at purchasing managers, but also at other managers, who may be involved in purchasing decisions and in dealing with third parties in this regard.

We hope that you will find this book useful.

1. Principles of good third party management

1 Principles of good third party management

The basics

Professional third party expenditure management begins with knowing

What you are going to buy

> *"The beginning of wisdom is to define"*
> **Aristotle**

Is it defined? If so, who specified it and why? 80% of cost is fixed as soon as the specification is decided. Does the specification start with input, throughput or output? Is it a defined by a supplier? If so, 'buyer beware'!

When you are going to buy it

Many products and services are seasonal and therefore when you buy can influence the price you pay. For example company audits tend to be seasonal with peak demand for year-ends in March and December, leaving available capacity for year-ends in June and September. And consider the reward mechanisms that the supplier may use for its sales person or team. Will the award of your business (perhaps the purchase of your next car) take them over the next threshold that gives them a much bigger bonus? If so, think about the timing of your decision.

Why you are buying this

> *"Buy not what you want, but what you need;*
> *what you do not need is expensive at a penny"*
> **Cato**

The best saving that anyone can ever make is not to buy rather than buy less or buy for less. End of aisle 'gondolas' at supermarkets are designed to get the customer to buy not what they need but what they want. Always challenge managers to ask do we need to buy this?

How much you are willing or able to pay

> *"A budget tells us what we can't afford," but it doesn't stop us from buying it'*
> **William Feather**

It is essential to know your limits: not only the maximum you are prepared to pay but also the minimum. What is the level below which you would expose the organisation to unnecessary risk by buying too cheaply? There may be a budget limit for this expenditure. Know this but ensure that it does not influence unduly how much you are willing to pay – that should be driven by the specification and the supplier market dynamics.

What your internal customer expects

> *"If you work just for money, you'll never make it, but if you love what you're doing and you always put the customer first, success will be yours"*
>
> **Ray Kroc**

Ultimately meeting and exceeding customer expectations is the key to success. Know who your internal customer is, what their expectations are and how you can manage them in the best way. Remember that you will usually have more than one internal customer, depending on the criteria (quality, cost, delivery, innovation).

End customer impact

The effect of third party expenditure on the external customer is the aspect that many managers miss most often, (they are so busy staring at the supply chain that they forget to turn around and look at their customers). The impact could be positive, improving cost effectiveness of the product or service and its value for money, or negative, reducing quality. If there will be little impact either way then the organisation must challenge itself to minimise the cost and effort of buying the product or service in question.

The numbers

Ensure that you understand, as much as possible, the numbers of what you are going to be buying. Too many poor spending decisions arise from buyers not understanding the detail of what they are about to spend. For example, the total cost of capital equipment when lifetime spares and maintenance are included is radically different from the initial outlay. It is important to understand this in the eyes of both the buyer and supplier. You, as the buyer, may see your expenditure as insignificant, but it may be quite the opposite to the supplier, or vice-versa. This will influence your sourcing and negotiation plan.

Above all make it as easy as possible for the supplier to give you their best offer

Whether it is due to poor data, poor process or bad buyer behaviour it is too often the case that suppliers are unable to offer the customer their best price. Lack of certainty in future demand will cause a supplier to add a contingency, as will a lack of confidence in the longer term relationship. Equally if the customer is unable to provide accurate data, either for the specification or future volumes, then the supplier is left to manage the risk, which it does by adding a contingency element to its pricing.

2. A strategy for third party expenditure - ‘how will we win?’

2 Developing a strategy for third party expenditure - 'how will we win?'

> *"Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."*
> **Sun Tzu**

In developing a strategy for third party expenditure management it is important to consider the organisation's aspirations and the goals for its supply base. Making significant savings requires high calibre staff and good technology. In contrast, senior managers may believe that the benefit to be gained from its supply chain is small when compared to its other strategic imperatives. In this case, unless a significant change can be achieved by taking a different approach, and assuming there is no major supply chain risk, the strategy for managing third party expenditure should be based on business as usual, rather than a transformation agenda.

In short:

- what is the greatest value that your organisation can derive from the supply chain?
- what should this focus on and how will you achieve it?

Consider what may happen in the future. Many would argue that coordinated, centralised procurement is the best answer, but if part of the organisation is going to be sold or demerged then retaining a decentralised procurement team will smooth progress.

It is important to consider how much you want to spend externally and why. Are there competencies and capabilities that you wish to keep in-house to maximise your competitive advantage or maintain your market knowledge? Typically these will relate to categories of expenditure that are important to the organisation, either for competitive advantage or business risk. On the other hand, keeping these capabilities in-house may need higher capital expenditure, which may not be available or may be better used on other projects.

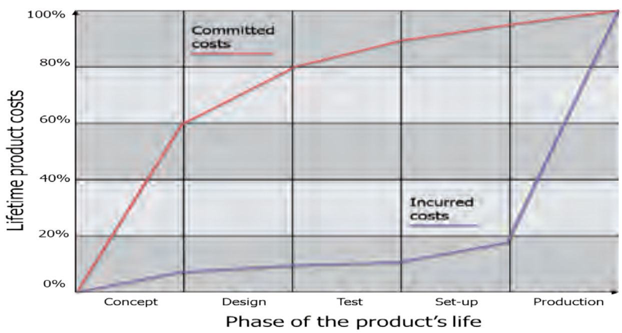
Think about the scope of your strategy: where will you focus and, equally importantly, where will you not focus? One of the most prevalent indicators of a well-considered strategy is that it identifies what the organisation will not do.

"The essence of strategy is choosing what not to do."
Michael Porter

Also consider how this strategy will differentiate itself and provide greater value than others (for example, HR, IT, Engineering) in the organisation. If the strategy does not achieve either unique or better value then it should come as no surprise if the leaders choose to prioritise investment in other areas. Typically, procurement plans will add greater economic value than those in many other parts of the business.

What will be the impetus for your strategy? Do you wish to buy always at lowest cost? Is quality the greatest priority (for example if you are in the supply chain for spacecraft)? Is continuity of supply the most important for the business? Or perhaps the organisation wishes to outsource more expenditure to enable it to flex volumes up and down to meet fluctuating demands. Lowest cost may not always deliver the biggest benefit - your greatest strategic priority may be to gain competitive advantage through innovation from third parties. Similarly the organisation may wish to buy products and services that enable the greatest profitability for its own product or service: this can often mean paying more.

It is important to focus on procurement for new products or services rather than those already in existence. Procurement will have far more influence (both positive and negative) early in the development process when designs are not fixed and suppliers are more willing to be flexible and innovative. The best managers of third party expenditure invest a large amount of their time influencing stakeholders and suppliers at the concept stage, as illustrated below.



All of these factors will change over time so the strategy for third party expenditure should not be fixed forever. It is essential that the strategic priorities for a supply chain are periodically evaluated , so that it can support operational changes as they evolve. This may be caused by changes in its business, changes at the supplier and/or the advent of new technology.

You should develop an approach that takes account of inputs, throughputs and outputs and is focused on maximising return on investment:

Inputs	Throughputs	Outputs
Skills and capability	Category management	Savings
Systems	Requisition to pay (R2P)	Sourcing decisions
Data	People development	Better suppliers
	Planning	New suppliers
	Supplier development	More capable people
	Performance measurement	
	Contract management	

Inputs

> *"If I had 60 minutes to solve a problem I'd spend 55 minutes defining it and 5 minutes solving it"*
> **Albert Einstein**

How many people are you willing to support and at what level of skill, experience and cost?

Within the procurement team (and others in the business) how much time is spent on which activities? The key to success is to have your people focused on the most 'value adding' activities (which include supply chain risk management). Processing requisitions is not one of them. How much do you wish to spend on procurement, either in-house or with an outsourced provider?

What technology will be used to support third party expenditure management? On what commercial basis will this be operated (licence, software as a service or something else?). Does the organisation work on a single or multiple IT platforms?

It is also important to consider the current context of the organisation's structure. If it is decentralised then procurement must support it in a customer friendly way (where the customers are internal contacts). More people may be needed and systems will have to be structured to show the value provided to each business unit.

Throughputs

How will processes be designed to ensure that the procurement function supports and enhances the performance of the overall organisation?

Typical throughputs of a procurement organisation include:

- Category management: the process by which the main categories of expenditure are managed, identifying the best approach to take to yield the best results and optimum category strategies for the organisation
- Requisition to pay (R2P): the transactional process that runs from someone identifying the need to buy something, through obtaining one or more quotations to placing an order and paying for the goods or services. There are many ways in which this process can be optimised, such as using pre-negotiated online catalogues of items for frequent requirements. Equally the R2P process should be designed to underpin category strategies. The best designed category strategies can easily be undermined by poor compliance to the nominated suppliers and/or negotiated agreements.
- People development: the continuing development of the procurement team is vital if it is to improve and stay ahead of the market. This can be achieved through focused training programmes, covering both soft and hard skills, as well as the latest and most relevant technology, coaching and on-the-job training. By developing your people the organisation will put itself in a stronger position to achieve year on year improvement in its third party costs at a much lower level of investment than if you replace existing staff with more highly skilled new hires.
- Planning:

"Opportunity arises for the prepared mind."
Louis Pasteur

Arguably the greatest and most frequent criticism levelled at a procurement organisation is that it is transactional and reactive. By establishing a structured planning process the procurement organisation can set its own priorities for the future and establish a platform for engaging proactively with the rest of the business. This activity is especially important as there will inevitably be a need to react to unforeseen requirements. The challenge is to ensure that the strategic agenda for the procurement team does not get lost or diluted amongst these reactive requirements.

- Supplier development: a strategy that improves the overall performance of your suppliers is essential. This will require more than working with those suppliers who are viewed as strategic and/or collaborative. You have to use tools and techniques that span the entire supplier base. In this sense procurement can often be like critics of the UK educational system, where there is regular focus on pupils who are gifted and those with special educational needs, leaving a forgotten middle that makes up the majority of the population. A small increase in the performance of the 'forgotten middle' will increase overall performance faster and further than activities at either end of the spectrum.
- Performance measurement:

"It is no use saying 'we are doing our best.'
You have to succeed in doing what is necessary."
Winston Churchill

What gets measured gets managed, so it is essential to have a strategy to measure performance. What will and will you not measure? How often will you measure it? To whom will you send the results? How will you use the metrics to set targets for improvement? In the context of third party expenditure management what internal performance measures will you have for the procurement team and what measures will you apply to the supplier base? How will you get suppliers to buy into improving their performance against these measures?

Contract management: once the sourcing activity is complete and a contract is set up this does not mean that procurement has no further management responsibility. Managing the contract to ensure that every ounce of value is extracted is as important, if not more important, than the original negotiation. But this requires a markedly different skill set from sourcing. How then will your organisation ensure it is ready and able to manage contracts well?

Typically, procurement teams spend too much time in meetings and carrying out transactional processes. More effort should be spent on:

- developing strategy
- planning
- understanding the supply market
- analysing data
- improving their skills.

The balance of emphasis between these elements will depend on the sector you are operating in and its maturity. If technology is shifting fast, such as in any sector with a high digital emphasis, then focusing on developing category strategy quickly and on supply market analysis will yield greater benefits than in a steady state sector.

Outputs

While savings are the lifeblood of any future strategy there are other factors to consider:

- **Make versus buy:** what are the activities that you wish to keep in-house? These should be the things that add to your competitive advantage. What would you be happy to outsource? Are there any goods or services currently provided by a third party that you would prefer to bring in-house, either to increase profitability or mitigate risk? Too often, organisations will outsource a requirement because they don't understand it or lack the necessary internal expertise to manage it.
- **Access to new technologies and methods:** are you able to gain access to these through your colleagues, do you need a third party to do this for your organisation or should this be a joint effort? Whatever route you choose, how will you ensure you have the right resources and approach to realise your goal in this area?
- **Savings, disruption and risk:** how much do I want to save? How much noise do I want to take away from the current structure? How much risk is the organisation willing to bear?

Elements of a strategy for third party expenditure management

Strategy can be defined in many different ways. Here is one, based on experience, consisting of six elements.

Cost

Third party costs can be split into two parts:

- **Current products and services:** never lose sight of these. If you lose control of today's costs there may well not be a tomorrow for the organisation. There should always be a budget and targets for reducing third party costs. The strategy should identify realistic goals and timescales for cost reductions, and ways in which these goals will be achieved (consolidation of expenditure, supplier negotiation, retendering specific requirements, supplier development, change in specification, demand reduction, reduce total cost of ownership, reduce the number of transactions, increase competition).
- **New products and services:** these have a much bigger long-term impact, so as much as current products will demand attention, new products and services need more attention as they will provide a greater return on investment. To manage this well you should employ the Pareto principle, focusing on the 20% of requirements that will make up 80% of your future expenditure. For the balance of items and expenditure, establish robust procurement processes to ensure that they are under control.

Supply base management

How many suppliers do you want to have? How many do you need? Of these, how many will be 'strategic'? See Chapter 6 for more explanation.

Supply chain development

How much can your current supply chain improve? In particular consider how much your suppliers can get better with little or no prompting. This may well be the case for suppliers in the leverage and non-critical item quadrants where competition will naturally drive ongoing improvement. For suppliers in the strategic and bottleneck quadrants some kind of supply chain development activity is needed in order to drive improvement.

People and skills development

People and skills development can be split into hard and soft skills. The hard skills refer to those parts that have measurable results. Some of them are specific to procurement and some are more broadly business based. Hard skills include:

- project management

- negotiation
- cost analysis (including total cost of ownership)
- contract management.

Soft skills include:

- relationship management
- influencing
- change management
- facilitation
- communication and interpersonal skills
- teamwork
- time and self-management
- decision making.

Research by Development Economics in 2014 put the value of soft skills to the UK economy at £88bn. Further details on the attributes of a great procurement professional can be found in Chapter 13.

Operating model

The operating model for any enterprise typically consists of organisation, processes, controls, technology and governance.

The first question to ask is do you need a team dedicated to manage third party expenditure? If the expenditure is not big enough then there is no need. At the other end of the spectrum, if the approach is established, processes are mature and most of the value has been captured from the supply chain then there is strong potential to push ownership of third party expenditure to the end users, with retention of a minimum level of governance. The third circumstance - where there would be minimal or no Procurement Department - would be where procurement is or can be outsourced to a third party provider. If this is the case then the organisation should retain someone or a small team to manage the outsourced provider.

In terms of organisation, think about the balance between the centralised and decentralised.

What range of roles do you need? The world of third party expenditure management now extends beyond the simple division of buyers between direct and indirect categories. What about supplier development, cost engineering, contract management, low cost country sourcing, planning and performance management? Should these be separate roles or do you have procurement polymaths who can turn their hands to any and all of these?

Even in a small procurement team if continuity of supply is more important than cost, then it may well be more valuable to have a supplier development engineer in the team rather than another category manager.

And what is the reporting line for procurement? This could be through the business units if the organisation is decentralised. It could report through Operations, which typically brings a greater focus on continuity of supply. If, on the other hand, procurement reports through finance it will tend to be hard on the numbers and soft on customer service.

More information about good practice in organisation design can be found in Collinson Grant's sister publication 'Managing Organisational Design'.

Process: in support of the operating model, ownership of the processes affecting third party expenditure (see Chapter 7) must be clarified. Simple things such as who can select a new supplier, who can raise an order or authorise a payment should be confirmed. This applies equally whether responsibility for procurement resides within or outside the organisation.

Technology: to support the selected operating model the supporting technology must be in place. This will cover the strategic sourcing and transactional procurement processes. More specifically this would include some or all of the software with functionality for:

- spend analysis
- request for quotation
- eAuction/electronic request for quotation (eRfQ)
- contract management
- requisition to payment process
- supporting catalogues of approved supplier products and services.

These are discussed more fully in Chapter 10.

Business planning

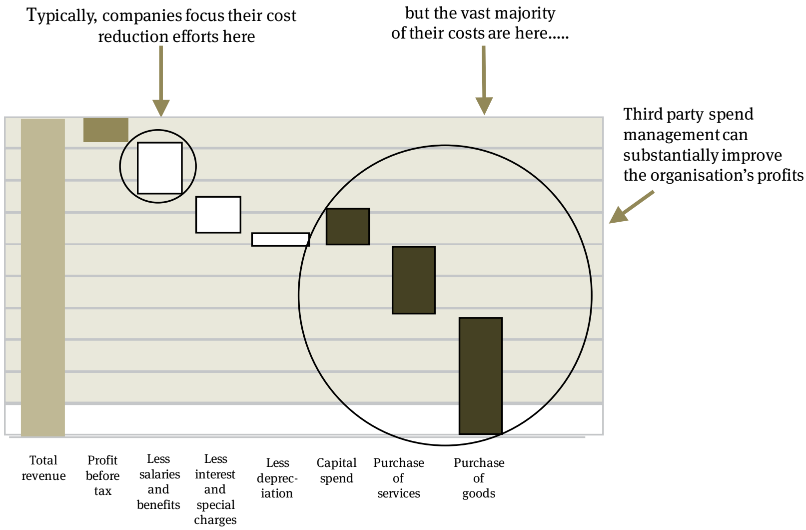
Procurement business planning should be conducted annually as a minimum and quarterly within larger organisations. It includes agreeing on spending and savings targets, usually with a focus on the next financial year. This then drives:

- resource planning: how many staff are required, at what cost, in which roles and with what level of skills? What people development activities are needed?
- technology: what will the organisation invest in?
- special projects: these include, but are not limited to transformation programmes, support for mergers and acquisitions and process changes.

3. Understanding third party expenditure - ‘show me the money’

3 Understanding third party expenditure - ‘show me the money’

For many businesses, especially those in manufacturing, third party expenditure represents their single biggest cost, yet many fail to realise the potential benefits of tackling it effectively.



Why is the focus often in the wrong place?

- Low priority – expenditure with third parties is regarded as a lower priority than other costs within the business.
- Lack of skills – there is an inability to analyse expenditure.
- Poor systems – systems do not analyse expenditure in a way that is user friendly.
- Ineffective or no categorisation – expenditure with third parties is not categorised and is therefore difficult to put into meaningful areas of focus.
- Poor organisation – some organisations are structured in a way that disaggregates the expenditure, diluting the focus.
- Lack of focus on the future – the organisation may be able to analyse current expenditure, but it is unable to understand how this will change.
- lack ownership of third party expenditure at Board level.

Spend analysis

Third party expenditure analysis can be done using 'spend analysis'. This technique gathers data on all lines of expenditure, usually from a download of Accounts Payable records - after all, if a supplier is to be paid then the expenditure must be third party. The information gathered should include:

- the value of the invoice
- the date of the transaction
- the business unit
- location
- supplier name and code
- currency
- invoice number
- item description
- quantity
- unit of measurement
- purchase order number
- spend category
- category code
- approved supplier.

A 'spend cube' can be built from this information. Depending on the number of lines of input data this can be done using Excel, a bespoke Access database or one of many specialist spend analytics technologies that are readily available in the market - either licensed or outsourced. As a general rule of thumb if there are fewer than a million lines of data you should be able to build the cube in Access and at a lower cost, assuming that your organisation possesses the data analysis skills. For more complex requirements you can use third party software, most of which is now cloud based. Alternatively if the organisation has an ERP system then this may have spend analysis functionality. The final option is to use a third party organisation to carry out the spend analysis, using your or their technology. A number of these specialist organisations now have sufficient experience to be able to provide benchmarks of expenditure per category as a percentage of total expenditure or as a percentage of the organisation's financial turnover.

In organisations other than the most advanced businesses only a limited number of the data fields will be available. It is therefore important to look to other systems (purchase order systems or even supplier data) to supplement and inform the analysis. Information from suppliers is often more helpful in providing deeper insight into services expenditure.

4. Understanding cost drivers

4 Understanding cost drivers

A cost driver is something that affects the cost of an activity. It may be internal or external. The relative importance of different cost drivers varies from one industry sector to another and also depends on the operational context.

This section looks at some of the internal and external cost drivers that may affect procurement decisions.

Internal cost drivers

Proprietary technology

The technological capabilities of an organisation will, to some extent, influence its procurement strategy especially in make versus buy decisions in a manufacturing environment. In this context, technology can be both a potential enabler and a potential constraint.

Manufacturing a product may involve proprietary technology, which is a competitive cost and/or differentiation advantage. A company in this situation is more likely to retain a distinctive capability in-house, especially if developing the technology has involved significant financial investment. Conversely, outsourcing is more attractive when there is a need to gain access to external expertise and technologies, which are not available in-house and where technology is changing rapidly.

The rapid rise of digital applications is resulting in technology becoming increasingly important. The challenge for procurement professionals is to understand the true cost and value of this and to manage it accordingly.

Planning horizons and lead times

The length of an enterprise's planning horizon depends on the nature of the sector in which it operates and how it organises its activities and resources to meet market demand. A long-term view is important in sectors where the lead time to provide or replace a resource is lengthy. When the nature of demand is less stable and less predictable, and resources are available more readily and are more flexible, a shorter-term view is more appropriate.

If items are purchased at short notice and on a short lead time, a potential opportunity may arise for the buyer to capitalise on excess availability and supply in the market. Conversely, market prices are likely to be higher when supply is constrained, resulting in the need to pay a premium.

Quality of information

Forecasting demand can be challenging, particularly in an uncertain economic environment. Robust sales and operations planning processes are essential.

If the future demand requirements are unclear then buyers cannot be confident of negotiating or planning for the optimum deal. Although some goods and services can be bought more cheaply through opportunistic spot purchases, in the majority of cases a clear, long-term plan of requirements will lead suppliers to offer a better price and create stronger, more sustainable relationships. These relationships will create benefits of their own: suppliers can be more willing to invest in innovation and new product development.

Frequency of delivery

The frequency with which materials and components for different types of manufacturing activity can be delivered by suppliers varies depending on the nature of the production process. For example in some types of batch manufacturing the timing of purchases and deliveries is influenced by production schedules.

Ideally an organisation should have sufficient availability of what it needs when it needs it without maintaining excessive stock. The balance between security of supply and good management of working capital is delicate. Materials requirements planning (MRP) is a methodology that facilitates component ordering as and when they are required by production. Minimising inventory also depends on suppliers' proximity and their ability to deliver the right quantities of a consistent quality at the right time. The length of the suppliers' supply chain will have a big influence on this.

Specifications

Getting the specification right will align costs with value provided to customers and can identify potential opportunities to use less expensive materials.

The Pareto principle can sometimes provide a useful framework. This is the '80:20' rule that underpins many situations where the most has to be achieved with scarce resources. If for example 20% of all specifications were to account for 80% or more of the total expenditure, focusing on these purchases can offer a better return on procurement effort.

Overhead allocation

The sale price of a product or service will include all the costs incurred in its manufacture or provision so that the business can generate a profit. Indirect costs, those that are not specific to an individual product or service, are typically allocated based on relevant cost drivers. The most suitable cost drivers must be identified so that appropriate cost rates for the different categories of overhead can be allocated. These cost drivers commonly include direct labour headcount to allocate indirect support costs and floor area to allocate property costs such as rent and rates.

Overhead allocation can affect the comparison of in-house and outsourced costs, which can influence purchasing decisions. The distinction between fixed and variable overheads is important. Some, but not all costs, vary with activity and not all costs vary in the same way or to the same extent.

Fixed and variable costs

Fixed costs (for example rent) usually depend on time and are unaffected by increases or decreases in activity. The rent that a manufacturer pays for factory space is not related to the number of items produced. This also applies to any other overhead costs that are incurred through contractual commitments. If production volumes were to increase beyond the capacity of the existing premises, additional rent would have to be incurred. However, within what is referred to as the 'relevant range' of activity, the cost is considered to be fixed.

Variable costs on the other hand fluctuate directly with different volumes of output and activity. Some categories of cost (such as utilities) have both a fixed element and a variable element. Organisations should try to understand those variable and semi-variable costs that are susceptible to changes in activity and could be saved if internal activity were to be outsourced.

An awareness of the relationship between cost and volume in the profile of a supplier's product can be a useful negotiating tool for purchases, especially if recurrent future orders were to significantly change the supplier's current activity level and production volume.

The opportunity for the supplier to achieve economies of scale from future orders may provide scope for negotiating a price reduction.

The best procurement professionals will consider these factors when negotiating, especially for capital equipment and new projects.

Life cycle costing

The costs of ownership of an asset or service do not all occur at the point of purchase. Initial acquisition costs, which are incurred between the decision to purchase the goods or services and before they are used, are only a starting point in the total cost of ownership. Other recurring and non-recurring costs will be incurred during the operational life of the asset or service. And there may be a cost to dispose of an asset or terminate a service agreement. A decision to purchase commits the user to these 'through-life' costs and there is usually little scope to change the cost of ownership after an item has been delivered. Keep a sharp focus on change control and cost monitoring. Recent experience with one client identified a 12% average increase in capital equipment costs between project inception and 'go-live'.

Life cycle costing methodologies consider the total cost of ownership. They provide a structured approach to determine the expenditure profile of a product or service over its expected life-span. Life cycle costing is useful in purchasing decisions where there is a choice of options as it provides a way to compare them.

Responsibilities for initial purchase costs and subsequent support costs may be allocated to different departments. It is important that such functional fragmentation is overcome when applying a life-cycle costing methodology.

Capacity utilisation

An organisation's decision to purchase an item externally rather than manufacture it internally may be influenced by the availability of production capacity. Under-utilisation of existing capacity is more likely to result in a decision to manufacture in-house rather than outsource. Conversely, constrained capacity will make outsourcing more appealing.

Productivity

Productivity was originally associated with manufacturing processes and is now widely used, with an emphasis on utilisation, performance and quality, in many service sectors too. Management tools and techniques, such as lean manufacturing and Six Sigma, that have a strong emphasis on reducing waste, have been widely adopted.

Irrespective of the industry, improving productivity will reduce costs. So it is relevant to purchasing (especially make or buy) decisions in both the private and public sectors.

Productivity is of course also affected by working practices. It is all too easy to be lulled into a sense of complacency about the way in which things are organised and done. Accurately measuring and monitoring productivity is important.

Successfully managing productivity also depends as much on an appropriate state of mind as it does on the tools and techniques used. A culture of continuous improvement is far preferable to the sudden imposition of drastic change.

External cost drivers

Raw material and commodity prices

Automation and technological change have over time reduced the relative significance of direct labour as a proportion of the total input cost in manufacturing. Raw materials have consequently become even more significant as a proportion of the total input cost.

Relatively low oil prices have had an adverse impact on oil producers but are providing a cost reduction opportunity for oil-consuming industry sectors (such as transportation).

The hedging of oil and other commodity purchases through forward contracts and other financial instruments may be considered to manage and mitigate risk. Such financial instruments can, however, prove to be costly depending on the actual movement of market prices relative to those in hedging contracts. Those entrusted with decision-making responsibility to hedge or not to hedge can be forgiven for thinking that it is a case of 'damned if you hedge, damned if you don't.'

Labour rates

Labour rates are relevant particularly in the context of decisions about whether activities should be carried out internally or outsourced. A significant global macroeconomic trend from the 1980s to the early years of the twenty-first century was the outsourcing of manufacturing production to lower-cost economies especially China and Eastern Europe. More recently, however, as labour rates in these countries have steadily increased - narrowing the differential with those in developed economies – compounded by the relentless increase in the complexity of customer expectations this trend has to some extent been reversed. As a result, manufacturers based in the West have relocated some of their operations closer to home (this is sometimes referred to as 'reshoring' or 'near-shoring').

By contrast, real wage growth in the UK has in recent years been relatively low. The UK's employment market has become more flexible with more part-time and temporary personnel. This flexibility has helped to reduce the relative cost of labour. Investment in expensive automation and technology may no longer be as attractive when a supply of affordable labour is readily available. Indeed some economists worry that a link between low wage growth and low productivity growth in the UK is running in both directions.

The advent of the National Living Wage in the UK prompted employers to invest more in technology and training to enhance their employees' productivity. Some employers, however, shifted to more flexible work contracts while cutting overtime, bonuses and other staff perks to mitigate the impact of the National Living Wage.

Exchange rates

The UK is a highly open economy, in which many organisations purchase - and are in some cases highly reliant on - goods and services sourced from overseas suppliers. Imports are typically invoiced in the relevant currency of an overseas supplier. Organisations are thus susceptible to the ongoing risk of exchange rate fluctuation and the risk of increased import costs arising from a depreciation of sterling in relation to foreign currencies. Market reaction to the unexpected outcome of the referendum in June 2016 on the UK's membership of the European Union is a case in point. Equally, President Trump's declared aim of 'America first', and his intention to reclaim international supply chains that have taken jobs away from the USA will affect those companies importing and exporting from that country.

For businesses involved in the importation of goods and services, currency risk brings an additional complication to supply market analysis and - depending on whether an organisation has a choice between local and overseas sourcing - may affect its perception of the preferred geographical profile of its suppliers and potential suppliers.

Foreign exchange hedging may be used to reduce currency risk. The two most common hedging instruments in this regard are forward contracts and currency options. A forward contract involves the purchase or sale of a specified amount of foreign currency at a specified future date based on a predetermined exchange rate. A currency option provides more flexibility in so far as the holder may (but is not obliged to) buy or sell a specified amount of foreign currency within a specified period of time at a predetermined exchange rate. Depending on the actual movement in the exchange rate for the relevant foreign currency ,it is possible to choose not to exercise a currency option but still potentially benefit from a favourable exchange rate movement.

Incoterms

International Commercial Terms (Incoterms) clarify the respective responsibilities of a supplier and a customer in relation to carriage and insurance costs, customs duties and other costs incurred in the cross-border shipment of goods. The point at which title to the underlying goods is transferred from a supplier to a customer varies depending on the relevant terms.

The appropriateness of potential incoterms needs to be assessed with reference to factors such as:

- the amount of control, which an organisation wishes to exercise over a shipment from a foreign supplier
- the complexity of compliance with customs procedures in the country of origin and its consequent impact on the potential amount of administrative time and effort required
- the organisation's ability to arrange transportation of the goods from their country of origin at a more competitive carriage rate than that quoted by a supplier.

A holistic understanding of the potential impact of different incoterms on an organisation's supply chain and its delivered costs is essential from a purchasing perspective.

Legislation

Legislation may influence purchasing decisions in different ways. Its impact on labour rates has already been explained above. Changes in UK tax legislation (such as the availability of capital allowances) have been known to affect the timing of capital investment.

Compliance with environmental legislation (for example relating to carbon taxes, energy taxes and renewables levies) also has a cost implication. Going forward, it is expected that the impact of such legislation will become more pervasive as the UK, together with other developed economies, strives to achieve a more balanced energy mix in the context of the government's ongoing environmental policy commitments.

5. Understanding suppliers and supply chain optimisation

5 Understanding suppliers and supply chain optimisation

How many is the right number of suppliers?

There is no proven scientific approach or mathematical model for identifying the right number of suppliers. There need to be enough to guarantee competition and the right level of innovative input. On the other hand there should be few enough that they do not create an administrative burden for the organisation and they enable the buying organisation to develop strong, strategic relationships.

There are a number of research sites (such as www.capsresearch.org) and advisors who will offer benchmarks for this. However, it should be recognised that these are based on a variety of businesses and do not take account of the individual organisation's situation, strategy and operating model.

What factors influence the number of suppliers that an organisation should have?

- Quality of products/services required: the more demanding the specification, the fewer the number of suppliers able to meet it. Equally it may be the case that the buying organisation lacks the bandwidth to manage quality issues across a significant number of suppliers.
- Complexity of the business: the more multi-site, multi-country and multi-product or service the organisation, the greater the number of suppliers it may require. In reality (beyond IT hardware) there are very few categories of expenditure that can be supported by a single, global supplier. Since this is the case it follows naturally that more suppliers will be needed and this will be magnified in organisations where there are many people who can nominate and use suppliers.
- Procurement organisation model: much as this should make no difference, if there are multiple parts of the organisation responsible for buying then they are likely to choose different suppliers, especially if there is not a consistent methodology for supplier selection.
- Customer requirements: in some organisations there may be a requirement from certain customers to deal with suppliers that they select. If this is the case the organisation should seek to ensure that it does not end up carrying the burden of risk from this supplier.

- Maturity of procurement strategy: in a relatively immature procurement organisation it is likely that benefits will be achieved through maximising and maintaining competition. As the strategy and organisation develops, it will improve its supplier management, supplier development and contract management capability and so will be able to sustain cost reduction through using these techniques with strategic suppliers, as well as ongoing competition in the leverage quadrant

- Creating 'integrator' suppliers: one way of consolidating many small lumps of expenditure is to establish an integrator supplier. A good example of this is in facilities management where you may choose to assign a single supplier to manage cleaning, catering, buildings maintenance, security and other sub-categories, rather than have first tier suppliers for each of these. The integrator may provide some of the services themselves and then sub-contract the rest to second tier suppliers, whom they manage. This can work equally well in purchasing direct categories, where components bought separately can be purchased as a pack or assembly. In this case it also helps to reduce excess inventories of the individual components, as these are held by the supplier.

Finding good new suppliers

"We're talking to every third-party supplier every day of the week, and our traders are talking to them and buying products from them. When we're doing that, we see opportunities which no one else sees."

Ivan Glasenberg

Keep looking, irrespective of when you may have a need. It is highly unlikely that the best offer will be available at the moment you decide to go to market with your requirement.

Ways of finding new suppliers

It is vital that a consistent, structured methodology for supplier selection is in place. This will ensure that suppliers are selected on a consistent and balanced basis. This should cover quality, cost, delivery capability, design/ innovation capability and management capability. Where appropriate you should visit the supplier to validate the scores given by walking their process and analysing randomly selected processes to check that they are 'walking the talk'. Always look to ensure that this activity is supported by all the relevant stakeholders and is not open to the challenge of being viewed as the procurement team's supplier and no-one else's. Equally assess the cultural match of the supplier with your organisation and their ability to grow and change in line with yours.

Ask your current suppliers who they view as their biggest or most dangerous competitors. Research the supplier market using the internet, your network of contacts (including peers in your competitors), trade bodies et cetera. Alternatively encourage or ask your existing suppliers to acquire new capabilities or businesses.

Understand the power of good questions and use these to qualify and differentiate between potential and new suppliers.

Paying attention to the right (number of) suppliers

Focus the majority of your attention on your (few) most strategically important and worst performing suppliers. Use ongoing and active performance measurement and metrics to raise the overall performance level of the supply base. Think about the context and situation of the business: is it expanding or contracting? Is it becoming more regional or international? The shape and number of suppliers should change to reflect the future direction of the business. Many procurement organisations struggle to drive improvement from their best and worst suppliers because they focus on too many of them. Use performance management to raise performance levels across the whole supplier base and use targeted efforts to drive improvement in a small number of your best and worst performing suppliers. Together they should total no more than 10% of your total supplier population.

Improving existing suppliers

There are three major components of supplier improvement, namely performance measurement, problem solving and process improvement.

Performance measurement should be applied to the whole of your supplier base, irrespective of size. Problem solving should be applied at the appropriate level of the organisation, depending on the size and potential consequences of the problem. A common challenge for organisations is that senior managers get dragged into solving minor problems, which is a waste of valuable resources. Process improvement should be applied to a very small proportion of your total expenditure or supplier base. It must be focused on the areas where the need or opportunity is greatest.

Performance measurement

What gets measured gets managed.

> *"In business, the idea of measuring what you are doing, picking the measurements that count like customer satisfaction and performance... you thrive on that.."*
>
> **Bill Gates**

QCDDM – quality, cost, delivery design and management is an established five point framework for measuring the performance of suppliers. This can be applied to direct and indirect suppliers alike, although it is generally more difficult to identify and apply consistent measures for suppliers of indirect goods and services.

Quality of products can be measured in terms of parts per million (ppm) defects. Results should be communicated regularly and formally to senior managers at the supplier to encourage good performance and motivate them to improve. There are many ways in which the supply performance of indirect categories can be measured. These tend to be more category specific. For example in facilities management (FM) in a law firm you may measure FM expenditure as a percentage of fees or as a percentage of operating costs. For outsourced logistics you may measure cost per cubic metre mile.

Cost – measure this both in terms of current goods and services and those for new products. Cost could be measured against targets that the customer sets.

Ultimately your performance management framework should motivate suppliers to improve their performance, independent of any input from your organisation. Your supply chain performance metrics should be aligned to the performance metrics of your overall organisation, keeping in mind at all times less is more in terms of the number of measures you have.

Problem solving

> *"As much as 95% of quality related problems in the factory can be solved with seven fundamental quantitative tools."*
>
> **Kaoru Ishikawa**

Having a consistent method of reporting and solving problems will reduce the effort required. If you have, say a seven step process, with established analytical tools to support each step, then when for example, someone says that a problem has reached step four, then others will understand clearly what has and has not been done. Also ensure you have a structured problem escalation approach. This will ensure that problems are managed at the correct level and that the burden of managing supplier problems rests in a balanced way on the organisation. The solution to every problem is not to give it to senior management to exercise their power and influence (also known as 'bang the table'). Too often, the high cost, high quality problem solvers in the business are saddled with menial supply chain problems. This is inefficient and a waste of money.

Process improvement

Again it is important to have a consistent, structured process improvement approach so that everyone knows how process improvement is being approached and what step it has reached. This should be based on a proven process improvement construct, such as Deming's plan-do-check-act (which he later changed to plan-do-study-act). Japanese manufacturing techniques such as fishbone diagrams, statistical process control, process mapping are all useful tools. Make sure you have the right tools at your disposal. After all:

> "*If you only have a hammer, you tend to see every problem as a nail.*"
>
> **Abraham Maslow**

In the cases of both problem solving and process improvement the business should establish consequences for continued non-performance. For example you may wish to declare that a supplier cannot be nominated for any new projects until these issues are resolved.

Exiting poor suppliers

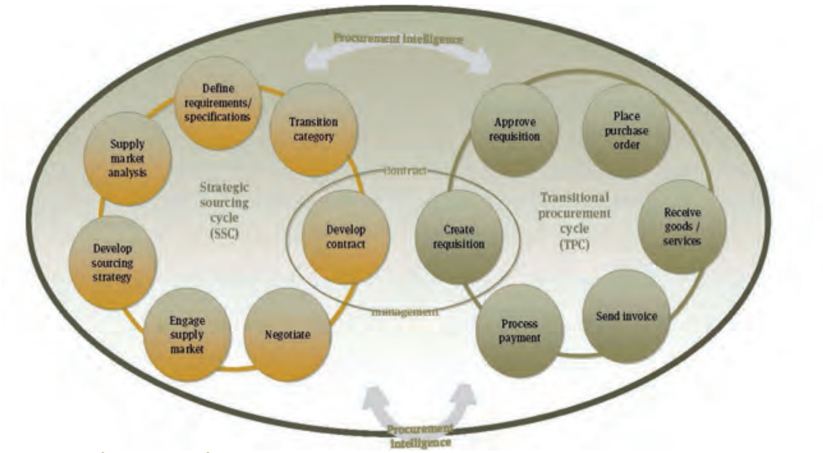
Don't ignore this. While this will not appear to save money it will reduce the complexity and risk that the organisation faces in its supply chain. Targets should be set at least annually and plans developed for specific, named suppliers to be exited. Any plan for exiting a supplier needs to cover all the relevant aspects, including cost, manufacturing/service provision capacity, tooling, transition plans and relationship management factors. The process typically has three stages:

- Plan: including an assessment of all the risks, communication with internal stakeholders, a proposed timing plan for the exit including interdependencies, one-off and recurring costs, resources required (testing, tooling costs et cetera). Always check the details of any existing contracts with the supplier.
- Communicate to the supplier and negotiate (if necessary).
- Execute the plan.

6. Understanding the core processes

6 Understanding the core processes

There are two core processes for third party expenditure management, namely strategic sourcing and transactional procurement. Strategic sourcing relates to the translation of a need into the identification and selection of a supplier and transactional procurement relates to the internal process that begins with a member of staff raising a requisition for an item through the raising of an order and the payment for that item.



Strategic sourcing

Strategic sourcing places an emphasis on a procurement cycle of continuous improvement and on an ongoing re-evaluation of an organisation's purchasing activities. It aims not only to reduce cost but also to enhance supplier performance and minimise supply chain risk. Strategic sourcing is used more extensively, though by no means exclusively, in larger organisations. It involves the following steps.

Define requirements/specification

A prerequisite of an effective strategic sourcing process is developing an intricate understanding of the relevant expenditure category. This includes variables such as the underlying commodities (if applicable), the volume requirements, the user profile and the processes in which the items are used. As the specification of an item is usually a significant determinant of its cost, cross-functional agreement on this at the earliest possible stage is essential.

To achieve greatest success consider whether you wish to base the request for pricing (RfP) on inputs, throughputs or outputs. In the case where an effective specification has been developed then inputs will serve you well. If you are buying a service then an output based specification may work better.

Conduct supply market analysis

"War is 90% information"
Napoleon Bonaparte

Before engaging with any supplier you should research the supply market and understand what is 'out there'. This is also known as supply market analysis.

A supply market should be analysed at the relevant level – depending on whether an organisation is able to source locally and/or globally – for potential opportunities and risks. The capabilities of different potential suppliers should be assessed in this analysis. Which tools to use will depend on how established the supply market is. For example, in a mature market then it may be easier to carry out Porter's five forces analysis, because more information is known.

Once again it is essential that there is a consistent and commonly understood methodology for carrying out supply market analysis. It may well be the case that different templates are used for assessing category suppliers of direct (products) and indirect (capital expenditure, products and services). For directs it is important and possible to assess and compare the capacity, available technologies, quality performance, design capabilities and locations of potential suppliers. For indirect categories it is more likely to be the case that suppliers' capacity correlates to the number of staff they have, which can be increased and decreased more quickly.

Supply market analysis will typically include an overview of the structure of the supply market and the major players, an assessment of: the level of competition (down to a detailed level – there may be greater competition in some parts of the category); product or service cost breakdown; cost drivers; risks; substitute products and services; political; environmental and sustainability factors; the organisation's importance as a customer and future technological developments.

For larger procurement organisations supply market analysis is outsourced to a third party organisation, sometimes based offshore.

The aim of supply market analysis is to provide insight and a point of view of how the organisation will go to market to source its requirements.

"The goal is to turn data into information, and information into insight."

Carly Fiorina

Develop sourcing strategy

A sourcing strategy should be developed at a category level irrespective of whether the purchase involves a product or a service. It may involve balancing considerations of cost against considerations of supply chain optimisation and potential risks. The sourcing strategy should include current and future expenditure projections, cost drivers and how these can be influenced, projected savings, current supplier base, potential other suppliers, desired future size of the supplier base, tools and approach to achieve the projected savings, a map of the stakeholders in the buying organisation and their views and preferences, technology development and potential changes and, if appropriate, competitor approaches and suppliers.

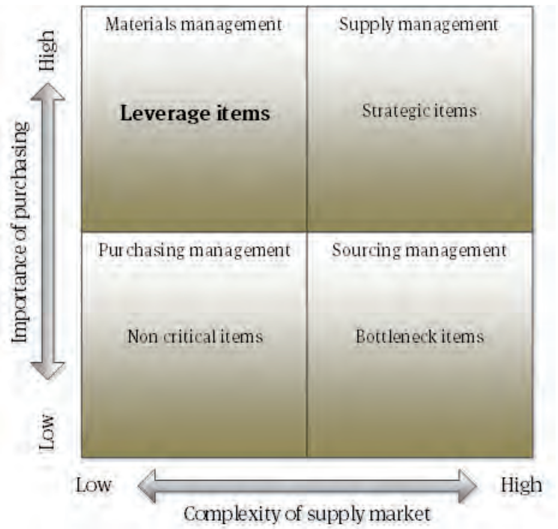
Engage the supply market

You would never consider going to a job interview without preparing thoroughly, having a good CV, understanding your potential future potential employer and perhaps even researching the individual you are going to meet. Sadly, all too often when companies approach the supply market, they do this with a clumsiness and naiveté for which they have only themselves to blame.

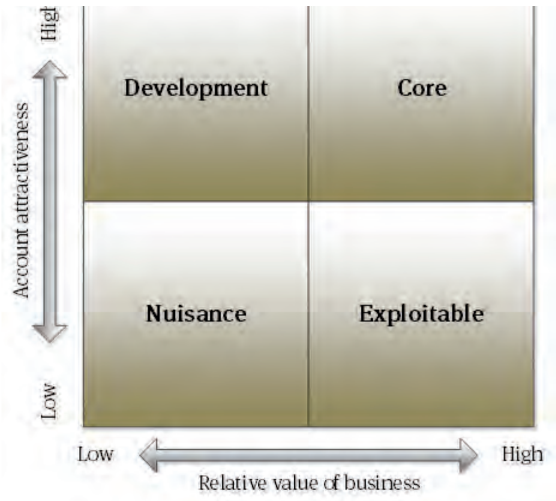
The nature of an organisation's engagement with the supply market will depend on (among other factors) the availability of alternative suppliers, the ease or difficulty of switching and substitution, the level of competition in the market for the relevant product/service and the receptiveness within an organisation to the possibility of using new suppliers especially if relationships with existing suppliers are entrenched.

The organisation should also consider carefully the relative power that may reside with each player in this relationship. The Kraljic matrix is a model developed in the 1980s (Purchasing must become supply chain management, P Kraljic, Harvard Business Review, 1983) that splits expenditure on categories into four elements of non-critical (also known as routine), bottleneck, leverage and strategic (also referred to as partnership).

Different approaches are recommended to be taken to categories according to where they lie in terms of their importance to the buying organisation and the complexity of the supply market.

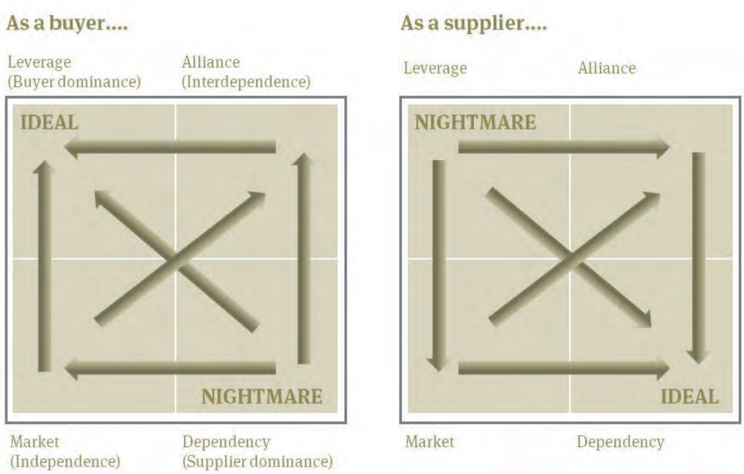


Which quadrant will this supplier sit in? Also, think about how they may view you. Suppliers typically view customers based on their own relationship matrix, shown below.



The buying organisation must consider not only how it sees the supplier but also how it is viewed by this supplier. The two views together will create the dynamics and (dis)functionality of the relationship. For example, if you as a buyer think the supplier is in the bottleneck quadrant and they see you in the exploitable quadrant, you are in trouble and need to find either another supplier or a way to buy little or none of the product or service. This is often considered in conjunction with Kraljic (see Chapter 4). It should be noted that in Kraljic's analysis you are positioning categories of expenditure, whereas the supplier analysis is done by account, rather than sales category.

These models are not without their weaknesses. (Cox, 2014) highlights a number of weaknesses. Kraljic's four box model is a static analysis, but relationships change over time due to shifts in power, other supplier or customer actions and their effect on suppliers, changes in technology. Kraljic focuses on supply markets and not on suppliers. The picture painted is black and white in terms of the nature of supplier relationships. In real life there are many shades of grey. The model also assumes a traditional supplier relationship, whereas today 'supplier' relationships take many forms, such as insourcing, outsourcing, joint ventures, contract manufacturing and others. For all that, the analysis is still a good starting point in assessing and deciding how you will manage your supplier relationships. You then need to be aware of the shifts in relationship that buyers and suppliers may be trying to achieve, as shown below, and to respond accordingly. Cox introduces the concept of buyer and supplier power positions.



These models all have value to a greater or lesser degree and they should be used on an ongoing basis when developing category strategies and deciding the next steps to be taken with any given supplies. Never forget that suppliers, categories and relationships change over time and so should your analysis. Whatever your view and approach, in the long term you get the suppliers you deserve.

Request for pricing (RfP)

This is typically done by using a 'Request for Proposal' or 'Request for Quote' process, which sets out product or service specifications, pricing, delivery requirements, payment terms and other conditions. This can vary in size and complexity. The advantages of a detailed RfP are that:

- suppliers know what is required and cannot cut corners in their responses
- suppliers can sense that the buying organisation is serious about potentially changing supplier and is not merely testing the market.

But the disadvantage is that:

- a detailed RfP may leave little room for innovation or improvement ideas.

Negotiation

Negotiation should be conducted with those suppliers, which have been shortlisted, initially by requesting further clarification and detail if appropriate and necessary. The effectiveness of a sourcing strategy may be - but is not always - enhanced by multiple rounds of negotiation.

This book is not intended to provide an in-depth guide to negotiation. There are many others that do this in the context of managing third party expenditure. As an overview there are typically five stages to the process.

Strategy and planning: one of the most important yet overlooked elements of negotiations is planning. Great negotiators spend around the same amount of time planning as good negotiators do. However, they will research from many more sources and so will be better informed and prepared.

Positioning and exchanging involves the setting out of each party's starting position, their needs and wants. While the illustration above shows five mutually exclusive stages the reality of negotiation is that it is an iterative process and therefore it is often the case that not all information and needs are mentioned at this point in the process.

The next stage is when the parties debate, barter, haggle, compromise and clarify over elements to be negotiated. While in the majority of supplier negotiations the primary focus and metric for the buying organisation will be the cost, there are many other factors to be considered, especially when there is a potential capacity constraint. In the close out phase it is important to cover all the relevant aspects that have been negotiated and confirm what has been agreed. At this point often one or more of the parties may introduce additional factors to be discussed.

Finally, once an agreement has been reached, write it down and communicate it to all the relevant stakeholders. If not there is a good chance that another cycle of negotiation will commence!

Develop the contract

The final decision on selection of the appropriate supplier is one, which should have cross-functional input. As a minimum, always involve the Procurement team or the appropriate commercial function, the end user of the product or service and your organisation's Legal department or advisor. Once a decision has been made, agreement with the relevant supplier should be formalised to remove contractual uncertainty.

Transition the category

Implementing a new supply arrangement can be challenging. The level of complexity will vary depending on the extent of change management, which is required. Whatever the complexity, however, it is important that the outcome of a new arrangement is tracked to ensure that its expected value is being achieved in full. This monitoring represents part of a continuous cycle, one in which the strategic sourcing process is revisited as and when appropriate in light of evolving external market developments and/or changing organisational priorities and requirements.

Transactional procurement

Aligning an organisation's procurement activities with its strategy, as described above, is then an important objective of procurement. It is, however, only one of its objectives. Goods and services need to be purchased to sustain an organisation's day-to-day activities. The term 'transactional procurement', also referred to as the 'Purchase-to-Pay' cycle, denotes the process of managing this purchasing activity.

The transactional procurement cycle typically involves the following sequence of steps:

- create requisition
- approve requisition
- place purchase order
- receive goods or services
- post invoice
- approve and make payment.

While the level of complexity in individual steps of the transaction procurement cycle may vary from one organisation to another depending on the size of the organisation, the steps outlined above represent fundamental steps of good procurement management. They should not be tailored and should be used as best practice in all organisations.

7. Tools/techniques: including cost analysis and negotiation

7 Tools/techniques: including cost analysis and negotiation

Cost comparison

Whether procuring a new product or service, or renegotiating an existing product or service, understanding the costs and cost drivers is an important factor in ensuring best value for money is achieved.

In order to do this, businesses should utilise at least one or more tools to understand costs fully. A difference between price and cost exists, where price is what a business pays for something, and cost is the amount of money it takes to build a product or service. If cost is understood in detail, more leverage is gained in order to reduce the overall price.

Using one or more of the techniques described below will enable businesses to understand costs of products and services.

Cost estimation

Cost estimation is an exercise conducted to understand the worth and probable cost of a product or service, using information available at the time. Estimated costs can be used for a variety of reasons including; funding capital programmes, leverage during procurement negotiations and general cost control. An estimate can be derived primarily by two methods; a static or dynamic estimate.

Static cost estimate

This method uses historic data which is adjusted to factor in any changes over time such as inflation. For example if a product has been purchased before or a similar project has been completed before, the cost of this is used to derive an estimate for what it may cost now. Factors have to be applied to ensure any changes in time or circumstance are reflected.

Dynamic cost estimate

Dynamic estimation also known as parametric estimation, involves using metrics as a basis to estimate costs. For example a facilities management company may provide an estimate to clean a building floor depending on the area, location and time of day. Factors such as the area and time of day are the parameters used to provide an estimate of the works required.

Value analysis

The concept of value analysis originated at the General Electric Company in the mid 1940's, specifically by Lawrence D. Miles and his colleagues. He described value analysis as a philosophy implemented by the use of a specific set of techniques, a body of knowledge, and a group of learned skills. It is an organised, creative approach which has for its purpose the efficient identification of unnecessary cost, i.e. cost which provides neither quality nor use, nor life, nor appearance, nor customer features (Miles, 1961).

It is a review process which systematically assesses a product to compare its function with its cost. Value analysis can be used as an effective tool for cost reduction by increasing the value of a product. It can also be used to eliminate wastage, improve the design, and develop new products.

Value is defined as the ratio between the function of a product or service and the amount it costs to produce. Increasing the value can be achieved in five ways:

- increasing the function as long as the customer is willing to accept a lower relative increase in costs
- increasing the function with costs remaining the same
- increasing the function, but reducing the cost
- keeping function the same and reducing the cost
- reducing the function but with a reduction in costs.

In order to increase the value, a systematic review needs to take place so that an analysis on the function and cost can take place enabling potential opportunities to be discovered.

A high level approach for conducting the analysis is to work through and answer these questions on a product or service:

- what is the product or service?
- what does it cost?
- what does it do?
- what else would do the job?
- what would that alternative cost?

The questions are not just asked of the overall product, but their constituent parts too. Through answering these questions, objective information can be collated and made available, so that decisions can be made.

A typical exercise of conducting value analysis on a product will have these stages:

Development of a team

A multi-disciplinary team is brought together, scope of works is understood and the product and its component parts are examined in detail. The team must include product experts, but also those who are able to provide a customer and commercial perspective. This will enable the right level of challenge to take place in order for opportunities to increase the value to be harnessed.

Functional analysis

Functional analysis is conducted to identify the functions of the product and how these are associated to the components. Each function has an associated cost and importance, these combined enable a list of functions, in order of value, to be listed. The functions at the top of the list are those that have higher cost and higher importance, and these can then be the source of finding ways to increase the overall value of the product.

Innovation

At this stage using the questions listed earlier can be a useful tool to start to think whether things can be done differently. Looking for ways to retain the basic function of the product is vital, but through innovative and creative thinking on the components or the function, a set of choices can be developed ready for evaluation.

Evaluation

Evaluating the innovations is a critical part of the process, at this stage feasibility assessments are conducted to ensure the objective of cost reduction is met, whilst ensuring vitally that the overall function of the product and adhering to its basic standards is maintained

Implementation

Any changes that have been evaluated and approved are developed and implemented. Rigorous actions plans and records should be kept to ensure a change history of the product is maintained.

Product teardown

Product teardown is the practice of taking a product and stripping it to its constituent parts. The teardown process enables a business to understand and analyse a competitor's or supplier's products in granular detail. This is typically conducted for two reasons; either to develop cost reduction opportunities, or to improve the design and functionality of the product.

The process of conducting a product teardown broadly consists of three stages:

1. **Planning** – Detailing clear objectives for the teardown, having the right interdisciplinary team to conduct the process and ensuring the required tools are at hand to record the teardown details are all necessary to ensure teardown yields the correct results.

2. **Disassembly** – this is the process of actually stripping the parts of the product. As the component parts are stripped, information should be captured. Typical data captured are; part number, part name, material, function, interaction with other parts, supplier, and design details such as weight and height. Having the right expertise present when disassembling is vital in this entire process. Those with the right skills will be able to spot insights that other unskilled staff may not. This is where improvement ideas and other insights are noticed and these should be recorded. Value analysis can be implemented here to add further scrutiny and structure.

3. **Analysis** – ultimately this process aims to understand the real value of the component parts and the overall product itself. All potential improvements in the parts and interrelated parts are analysed, typically through a feasibility analysis. The analysis will enable the purchasing department to source similar parts/products and understand what the real value and therefore the cost of the product should be. This would in turn provide provide more negotiating leverage when determining a price with a supplier.

8. Contract management/supplier relationship management

8 Contract management/supplier relationship management

Once a contract is agreed it should not be put in the (metaphorical) drawer where it gathers dust. A consistent level of focus on the contract and its terms will ensure that the right level of operational tension exists. This ensures that performance is maintained and improved. Excellence in contract management covers:

Relationship governance

Who communicates with whom? In what ways? How often? Stakeholders who have something to gain or lose should be involved continuously. This may be in the form of a formal meeting, receiving regular performance reports or ongoing informal communication.

Commercial management

The focus of commercial terms in the contract should drive performance. As mentioned earlier, the organisation should consider whether it focuses contract performance and monitoring on inputs, throughputs or outputs. If there is a strong need for compliance, then it is better to focus on inputs. If the emphasis is on performance rather than compliance then outputs will drive better supplier performance. While they are not be advocated in many circumstances the use of performance-based fees can act as a catalyst for improvement. If these are used there needs to be a robust measurement and audit process supporting the calculation and proof of the performance payments. Too often these can be crude and not thought through, leading to unnecessary additional tension in the relationship.

Quality management

This covers not just the ongoing requirement for quality supply but also the responsibilities and actions to be taken if, as and when something does go wrong. In addition a set of consequences for poor quality performance should be defined. These will ensure that if something goes wrong, the supplier will take active ownership of resolving the problem quickly and in full.

Service definition

Being clear about the service provided, including roles and responsibilities lies at the heart of good contract management. Too often contracts have been established that lack delineation of the buyer and supplier's responsibilities. This leads to time consuming friction in such relationships. Requirements should be defined at the strategic and managerial, as well as the operational level.

Demand management

Perhaps the greatest area of savings opportunity lies in demand management, irrespective of whether a product or service is being purchased. Clarity of demand management for products will include, but not be limited to, a clear, mutually agreed bill of materials, a defined amount of schedule cover and, if necessary, additional cover for raw materials (advisable where there is limited raw material availability or competition for high quality raw material) as well as a defined process and commercial agreement for dealing with faulty products. For services, great attention should be paid to the amount of skilled management support that is required to ensure the best service, as well as the variation in quantity of service required over time and how peaks and troughs will be managed.

Performance management

We have already covered this; however in this context there must always be consequences for poor performance. This could mean no new business is awarded to the miscreant supplier until it improves, loss of share of customer wallet or a financial penalty.

Risk management

The focus of risk in contract management may include loss of production/ service provision, legislative and environmental compliance and other issues that might affect an organisation's brand, such as slave labour or other poor employment practices in the supply chain.

Supplier management covers the deployment of an approach to deliver an appropriate relationship between the two organisations in order to achieve the best outcome. This is often driven by a relationship model, such as (Kraljic, 1983). It is important to establish a clear operating model for who communicates with whom, in what way, saying what and how often.

Supplier innovation

It is vital to capture and realise the best ideas that come from your suppliers, especially if these can be secured for your organisation alone. Many approaches have and are being taken to this, ranging from joint innovation workshops, to commercial agreements for sharing savings from innovation ideas. As a buyer the biggest focus should be on identifying those suppliers and ideas that can bring the greatest value for your organisation and focusing your attention on realising these as quickly as possible and before or at the expense of your competition. And remember that innovation may occur not just in the product or service provided but also in the way your organisation works with its suppliers.

Monitoring supplier performance

All too often, a purchasing department may spend considerable time and effort negotiating a contract with a supplier, but subsequently omit to monitor the supplier's performance in relation to the agreed contract. Good purchasing practice, however, dictates that an organisation should understand what it is receiving in comparison with what it has contracted to purchase. It is important not only to know the extent to which a supplier may or may not be meeting the relevant contract criteria but also to identify the potential scope for improvement.

Where more complex long-term supply agreements are in place, a supplier's performance needs to be monitored on an ongoing basis. At the inception of such contracts, there is risk and uncertainty for the customer. Only over a period of time does a supplier's performance become apparent and can it be evaluated against the criteria specified in the contract.

Continuing engagement with suppliers also facilitates greater mutual understanding and collaboration. The pro-active management of such relationships can sometimes pre-empt potential difficulties and problems. It needs good relationship management skills.

Supplier performance can be assessed with reference to key performance indicators (KPIs) such as:

- consistency of product quality and proportion of items rejected
- timeliness and completeness of delivery (commonly referred to as 'on time and in full')
- service quality relative to service level agreement
- warranty claims (if applicable)

- customer service responsiveness
- quality of account management
- accuracy of invoicing
- payment terms.

It is good practice to include metrics of measurement in all supplier contracts so that quality, price, delivery and service levels can be monitored. Performance criteria should be set out in such a way that there is a clear and consistent mutual understanding of what is expected.

The relative importance of the above key performance indicators (KPIs) varies from one industry sector to another and also depends on the operational context. Irrespective of the sector and the context, however, KPIs should be sufficiently meaningful to facilitate a holistic view of supplier performance.

Other considerations, (such as ethical issues, sustainability issues, cultural fit), are relevant too, but perhaps less susceptible to KPI measurement.

It is important that the purchasing department should engage with personnel in other business functions, which have interaction with a supplier, to assess a supplier's performance. While some comments from individuals on the quality of such interaction may be anecdotal, they can all contribute to a more rounded understanding of how a supplier is performing.

Supplier performance monitoring can be time-consuming. It is thus important that time and effort should be allocated appropriately. Key suppliers of goods and services involving high value and high risk are typically prioritised for such performance monitoring (see comments in Chapter 11 on potential outsourcing of tail spend management).

9. Enabling technology

9 Enabling technology

It can be argued that by comparison with other functions (operations, sales, HR) procurement had been slow to come to the technology enablement party. However, this has changed dramatically in recent years. Technology is now, by and large, available to enhance procurement processes, improve productivity and deliver better results.

Microsoft Excel was unsurprisingly a common starting point and the initial analytical tool for many buyers. As manufacturing resource planning (MRP) and enterprise resource planning (ERP) systems became more commonplace some of their functionality could support purchasing decisions. But in many large businesses, with global or regional operations, everything was not always as easy as it first seemed. Different sites turned out to have different versions of systems, and different protocols had been used for collating and coding data. The goal of having access to consistent data sets throughout a large, dispersed company seemed as elusive as ever.

As the potential for automating buying processes became more obvious then the development of specialist procurement software started to take off. Programs and modules came on to the market for tasks such as e-procurement, reverse auctions, contract management and spend analysis. Each had effective functionality but was, as yet, self-standing with little connectivity. These applications are now being effectively combined in targeted systems aimed at automating, managing and improving functional procurement requirements.

The priorities for procurement professionals now are to master the efficient application of enabling technologies, and:

- to learn and use the technology as part of business as usual
- to resolve the complexities of data gathering that feeds these technologies and makes or breaks their success
- to select the right (combination of) technologies that will enhance the contribution that procurement makes to the organisation
- to understand and address how the enabling technology for procurement will integrate with other technologies used by the organisation
- to understand and monitor the costs and benefits of new approaches to procurement.

The challenges of procurement technology

The challenges of procurement technology are several fold. The first is that there is usually no single technology platform that covers all the areas where enabling technology is available. As ever, there are decisions to be made, compromises to be considered and arguments to be had on the level of investment needed to yield a positive return.

The platform on which you operate

An ERP system may have been based on older platforms than the well-known technologies of SAP, Oracle et al. This is certainly still true for some surprisingly large businesses. Too often procurement professionals have failed to make their voices heard in terms of the technology requirements they have. The buying function has had to take a back seat after the demands of operations and finance.

More specifically there are specific ERP challenges that must be addressed.

- Robustness and completeness of data: just because you have an ERP platform does not mean that you will automatically have it fully populated.
- Differing versions of the software in use in different parts of the business. The result of this is that work may be required to get the data into a consistent format.
- Levels of access: in one well-known global technology company ten years ago they had a single instance of SAP. However because of the governance in place throughout the business procurement was not permitted to access the expenditure data without going through a series of approvals.
- Ease of access: it is a simple consideration but do the buyers have powerful enough technology and a good enough signal to get hold of the data they need?
- Impact of mergers and acquisitions on data: if a company has bought, sold or merged with another business then there are likely to be some or all of the issues listed above. Indeed it may well be operating on more than one ERP platform, in which case the most effective solution may be to 'suck' the necessary data into a third, more flexible solution.
- Mastering the data: in one large, well-known bank that had made a number of acquisitions, at one time they had twelve staff working full-time on consolidating, cleansing and making their expenditure data consistent so that it could be used by the buyers. This may appear like an

over-investment but it ensured that negotiations were based on reliable, credible data and that they delivered significant value for the business.

The advent of cloud technologies has reduced the need for upfront investment in hardware and has meant that organisations can move quickly from being a laggard to a leader. It has also meant that new entrants in the procurement technology market have been able to establish a strong foothold. The benefit of these technologies is that they can sit alongside the existing ERP platform and draw and supply whatever data is needed. This avoids the need for a sizeable IT integration project.

The cloud is not for everyone. A significant number of public sector organisations have been slow to take up this solution because of fears about data security. And cloud technology is not the exclusive answer to the procurement technology conundrum. For example, it can be used along with mobile apps to enable remote users to access the best approved supplier deals. This is particularly relevant for dispersed multi-site operations such as oil and gas companies.

Evolving technologies

Other new technologies will inevitably offer different opportunities. The problems of collating and distributing data from worldwide locations may be facilitated by using the Blockchain architecture. It claims to offer new levels of visibility, traceability and trust. The concepts behind the 'Internet of things' may offer different approaches for sourcing data from previously awkward sites.

The other potential area of benefit is in the use of social networks. At present there is little evidence of this happening, although it would appear to be a natural means of promoting ideas generation across procurement teams and supply chains. Crowdsourcing is another technology that procurement professionals have yet to exploit.

Where and how does technology fit now?

One of the biggest challenges is that there is no recognised, single technology solution that covers all the bases. Specialist providers have typically been strong in two to three, as opposed to all of the areas listed below. There is no single provider who can claim to be a leader in all areas. Many of these companies have grown through acquisition and so, just like some of their customers, they have integration issues of their own with their technology.

Buyers should always pay attention to how joined up the technology offered really is that they are being offered. Technology can improve the performance of all the following procurement related processes:

- Idea generation: there is massive potential in this area through crowdsourcing, supplier enabled innovation and other technologies. However these tools have not been developed typically by the mainstream procurement technology providers as a core part of their armoury. Equally, looking at the non-technological aspects, it is essential that any organisation wishing to generate a high number of good quality ideas must have a working culture with its internal stakeholders and external suppliers that encourages and rewards the practice.
- Supply market research: in the past this task has been focused on snapshot views, for example a Dunn and Bradstreet report that may be using year end data that is months old and does not reflect current performance. To get better value from this aspect, organisations managing third party expenditure need live, real-time information feeds. In addition they should develop an operating model in the business that is able to respond quickly to these changes. As one example, there are many cases of hedging (for currencies and/or raw materials) where companies had the information at their fingertips, yet their organisational wheels moved too slowly to respond appropriately.
- Product/service development: a number of technologies have developed over time to address the opportunities that exist. These include tools to define and agree design characteristics through to search engines that will identify equivalent (standard) products. The challenge in this area is that technologies have developed from different starting points, usually either technically or commercially driven. Integrating these technologies to make a significant difference to the process is not easy. Equally, proving the business case for these technologies is less straightforward and clear than for, say eAuctions, where the bang for the buck is evident.
- Sourcing: technology to support this process covers spend analysis (see section 4.1), electronic requests for quotation (eRfQ) and reverse auctions (also known as eAuctions). In the cases of eRfQs and eAuctions the technology is used to capture the buyer requirements, communicate these to the bidding suppliers, receive tenders and compare bids. While eRfQs do this over a similar period to a paper-based tender, eAuctions compress the bidding process.

The benefits of such systems are that they provide a more robust audit trail than a paper-based or face-to-face process. Also, over time they will help the organisation to build up a knowledge base of bidding companies and a pattern of their bidding habits.

eAuctions

eAuctions are applicable when the following criteria apply:

- the buying organisation has a clear specification of what it requires. This can apply equally to a service as well as a product
- there is a sufficient number of credible, competing bidders, usually four or more
- there is a significant enough amount of business on offer via the eAuction
- there is sufficient capacity in the supply market for the product or service being auctioned.

From experience, eAuctions have been shown to yield incremental savings of 5-25% over and above a traditional RfQ. Auctions can be run in several ways: one is where each bidder has visibility of their bid and the best bid; another is where each bidder can see their bid details plus their ranking in the bidding. Other methods such as Dutch and Japanese auctions are available but are less widely used. Bidders cannot see how many other bidders are in the auction. In these ways the potential suppliers are incentivised to improve their offers.

The technology to support these activities is available in many of the big ERP systems. If the organisation already has one of these then it is likely to provide the most cost effective solution. However, if the organisation has a choice then there are many niche solutions in the marketplace that often have more functionality. These are now often cloud based. As long as this does not represent a security risk for the organisation then this option will probably offer the best solution.

Purchase to pay

Both ERP systems and niche solutions offer options for managing the transactional procurement cycle. The benefits of technology both enhance value and reduce risk for organisations of all sizes that implement them. Even when an organisation has understood its expenditure and has carried out many RfQs and/or eAuctions there remains the challenge of ensuring that people use the suppliers who have been selected. Purchase to pay technology helps to guide staff to use these and only these deals and so maximise compliance to the nominated supplier and agreed pricing. This is underpinned by the use of online catalogues, which can be customised to ensure that staff buy only the approved products and services. The system also ensures that the correct approval flows are followed and the right level of authorisation secured for all purchases.

Contract management

It is not sufficient to use technology only for the strategic sourcing and transactional procurement processes. Once the supplier is selected, the agreement is in place and ongoing requirements are being provided there is a need for effective contract management. The aim of this is to monitor who is buying how much, where and when, which may lead to improvements in demand management and/or pricing (if actual volumes being purchased are exceeding those on which the deal was based). It can also highlight examples of non-compliance with the approved supplier agreements. While technology in this area is less widely developed than for source to contract and purchase to pay, it does exist and can help organisations deal with complex challenges. For example, some companies may wish to declare and provide evidence that their supply chains are compliant with relevant legislation or slavery free down multiple tiers (seven in one case). Contract management software can support this well. And robots can be potentially be used for similar functions and to source external data.

Supplier performance management

Several technologies have emerged in recent years that help organisations to measure the performance of their suppliers. More often than not these will be tailored to the specific KPIs that the customer organisation has. Because of this, such technology can be slow to implement. It is likely to yield more benefit for organisations that spend the majority of their costs with third party suppliers and those who have a high proportion of strategic and bottleneck suppliers, where gaining value from resourcing to new suppliers is less likely.

Compliance management

This could cover a whole range of compliance aspects, from levels of compliance to approved supplier deals, health and safety, environmental legislation, ethical standards such as an absence of slavery or corruption in the supply chain and other areas. While this is easy to develop in theory and does not necessarily require a complex technology base, it often proves more difficult to execute through the supply chain, especially when they are multi-tiered, global and complex.

Supply chain risk management

While risk management takes a lower profile when the global economy is growing it is nevertheless important to maintain. Supply chain risk should be measured in terms of the likelihood of the risk occurring and the impact on the organisation of it does happen. Equally the organisation should establish which risks it wishes to measure and how often. These include but are not limited to business continuity, which may be driven by financial or physical supply issues (which suppliers might go out of business/capacity constraints including raw materials), quality, legislative compliance (see above) and management constraints.

The challenge is to decide on and apply technology that is easy and cost-effective to use.

Integration

The adoption of better software tools to support procurement should (in virtually all cases) be carefully integrated into a company's wider information technology framework. To state this should almost be unnecessary – but, as we know, things don't always follow that pattern. However, there are real benefits when operational integration has been achieved. For example:

- real-time links with finance/treasury/accounts payable teams
- effective supply chain optimisation, better inventory control, reduced bottlenecks and successful just-in-time operations
- timely engagement with human resources to ensure proper regulatory and statutory compliance for contractors
- improved management information and reporting
- effective use of IT support for system development and maintenance
- enhanced product development and launch, supported by better component availability.

Summary

Most dedicated procurement/third-party expenditure functions are now supported by one or more specialist IT systems that have the potential to improve the outcomes of buying decisions, reduce timescales and get better value for money for the enterprise. There should always be a complementary investment in training to ensure the system is used as efficiently as possible. As with any asset the performance of technological tools needs to be assessed regularly to ensure they continue to yield the promised benefits. Data – its collection, coding, cleansing, management, security and analysis – remains the foundation for success.

10. Governance

10 Governance

Policies for managing third party expenditure

It is important that purchasing activities are underpinned by an effective governance framework. This should be reflected in an organisational structure for decision-making, as well as in appropriate policies, procedures and internal controls - together these can help an organisation to develop its purchasing capabilities.

Clear policies help to ensure that an organisation's purchasing activities are consistent with its overall purchasing objectives. Such objectives may include achieving value for money, minimising the potential risk of supply chain disruption, acting in socially responsible ways and reducing potential reputational risk.

Purchasing policies should be simple, but robust. They should also be well-documented. A clear, company-wide mandate to comply with these policies should be in place.

All manageable external spend should be coordinated by the purchasing department. Purchasing personnel should be empowered to make decisions on behalf of an organisation in accordance with its policies and procedures.

Examples of such policies and procedures are given below.

Authority levels

The authorisation process should be set out in a formal approval matrix with clear limits of purchasing authority. In setting such authority levels, there should be an appropriate balance between optimising transactional efficiency and maintaining effective control.

Ethical standards

Purchasing activity should be based on ethical principles including accountability, fairness, impartiality, probity and transparency.

Fair competition

There should be sufficient engagement with the relevant supply market to promote competition on a level playing field between potential suppliers.

Selection of suppliers should be based on their ability to meet fair and objective criteria.

Contract management

Formal contracts should be in place for categories involving high value and/or high risk. From time to time supplier contracts should be re-appraised and subject to open and transparent competition to provide new suppliers with an opportunity to gain business and to provide access to the best offering currently available in the market.

Supplier imposition

A customer may specify that an organisation should use a particular supplier. In such a situation, the purchasing department should ensure that the decision-making process for appointing a supplier is visible and transparent.

Reciprocal trading

This is also known as 'countertrade' and refers to a situation in which being a customer of an organisation is a condition for being a supplier. This is acceptable only if there is no coercion, both parties are in agreement and there is mutual benefit and transparency in the reciprocal arrangement.

Confidentiality and intellectual property

Confidential purchasing information and/or intellectual property should be appropriately safeguarded.

Conflicts of interest

Potential conflicts of interest should always be declared and managed.

Environmental sustainability

Enterprises are trying more than ever to balance environmental and economic considerations. Sustainable purchasing policies can potentially help to reduce: waste and pollution; greenhouse gas emissions; excessive water consumption; and to mitigate environmental risks in an organisation's supply chain. They can also promote greater resource efficiency by saving energy, reducing packaging as well as encouraging the re-use and recycling of materials.

Gifts and hospitality

There should have a clear policy on accepting business gifts. Normally only items of small intrinsic value should be considered acceptable.

Whistle blowing

Bribery is a criminal offence in the UK and in most other countries. It should not be tolerated by those involved in purchasing, who share a duty (with their counterparts in other business functions) to alert senior management if they become aware of any such activity.

Compliance and risk

Compliance is an essential element of risk management in purchasing. Compliance procedures should be structured around different stages of the purchasing cycle and should address various risks at successive stages of the cycle. The relevant procedures should be straightforward to apply and should also be supported by regular training and awareness activity for all personnel involved.

Legislation

All organisations must act within the law. The potential consequences of breaching the law can be very serious. Complying with relevant legal requirements is essential. Managers thus have a responsibility to develop, implement and maintain an effective framework of legal compliance. This should be embedded into an organisation's purchasing policies, procedures and internal controls. The board of directors should review this compliance framework periodically to gain assurance that it is effective.

Corruption

Compliance processes should be underpinned by three underlying principles:

- fairness: all eligible suppliers should have the opportunity to quote
- transparency: purchasing activity should be based on open, known and documented procedures and on objective criteria for awarding business
- competition: there should be sufficient engagement with the relevant supply market to promote effective competition between potential suppliers.

Purchasing is, however, susceptible to corruption. The financial implications of purchasing activity are often significant. Contracting processes may also be complicated and detailed. Corruption in purchasing can manifest itself in different ways such as demands for up-front payment, failure to meet specifications, frequent requests for contract renegotiation and over-invoicing. It can be challenging to detect because of the volume and complexity of the transactions entered into by an organisation.

Effective purchasing compliance is a form of corruption risk management. It comprises among other things effective internal controls, clear guidelines, reporting procedures and adequate protection for whistle-blowers. It helps to monitor purchasing processes, identify and detect fraud and corruption at various stages of the purchasing cycle.

The potential benefits of compliance activity include:

- It translates the principles of fairness, transparency and competition into practical reality
- It facilitates the evaluation of purchasing decisions and the identification of potential irregularities
- It helps to ensure consistency of conduct in all purchasing activity.

Compliance checklists are often a useful tool. These can be found in different formats, but should be tailored to the specific requirements relevant to an organisation. They should be user-friendly and should apply a step-by-step approach to each stage of the purchasing process. Appropriate guidance should be given with regard to the situations in which a checklist should be used and who should use it and the appropriate follow-up action if a checklist flags up the risk of potential irregularity.

Purchasing activities may also be subject to compliance reviews. This will, however, depend on the size of an organisation and its availability of resources.

It is important that the purchasing personnel remain alert to the need for continuing compliance activities. Appropriate training activities should focus not only on relevant rules and procedures but also on how to identify fraud and corruption risks at different stages of the purchasing cycle.

Environmental

Purchasing personnel need to be aware of the potential environmental implications of their decisions and actions. Such environmental implications may for example include:

- resource efficiency and sustainability
- use of hazardous materials and potential land or water contamination

- waste management and potential recycling
- potential impact on air quality.

Appropriate risk management involves assessing the potential environmental impact of products and services. Suppliers and potential suppliers should be asked through questionnaires about how they are managing the environmental impact of their activities: their feedback can then be used to rank them according to their environmental credentials.

In the UK, the BS 8903 standard ('Principles and frameworks for procuring sustainably') provides a comprehensive framework to help organisations manage environmental sustainability in tandem with economic development. It sets out useful guidelines for implementing sustainable procurement processes in a supply chain.

Reputational

Globalisation of the world economy has resulted in unprecedented levels of international trade. This has been manifested in among other things increased sourcing by organisations in developed economies of products and services from overseas suppliers in less developed economies.

At the same time, organisations' approach to corporate social responsibility (CSR) is under scrutiny as never before. Businesses recognise the significance of their brand and the risk of potential brand dilution arising from even the slightest hint of doubt about their ethical integrity.

In a purchasing context, ethical sourcing may once have been considered a 'nice to have' feature of organisational behaviour. Today, however, the expectation of strong business ethics is taken for granted.

A CSR policy should be meaningful and robust. But the commitments an organisation makes should, however, also be realistic and practicable. Their relative emphasis will vary from industry sector to another.

Purchasing personnel cannot develop a supply chain CSR framework in isolation. They can only do this in conjunction with other relevant business functions.

Relevant social and human rights criteria include:

- country of origin

- minimum working ages
- forced labour
- working conditions
- wage levels.

Suppliers and potential suppliers should be asked through questionnaires about how their employment practices comply with acceptable standards of social and human rights. Information should be requested and reviewed periodically and appropriate action taken if necessary to mitigate an organisation's reputational risk.

11. Organisation design

11 Organisation design

In-house

The extent to which a purchasing function should be centralised or decentralised is the subject of perennial debate. There is, however, no ‘one size fits all’ approach.

Centralised

The main benefits of centralised purchasing activity are:

- greater scope for standardising specifications
- greater potential for more economic purchasing through buying larger quantities on fewer occasions
- reducing administration and costs resulting from lower transaction volumes
- the possibility of greater staff specialisation and thus increased knowledge of spend categories and the relevant suppliers
- stronger financial control.

A centralised purchasing structure is orientated towards prioritising effectiveness and efficiency. It is more suitable in organisations where:

- there is potential scope for more economic purchasing and consequent cost reduction
- there has been insufficient compliance with purchasing policies and procedures
- a transformation of purchasing activity is required for one or both of the above reasons.

Decentralised

The main benefits of decentralised purchasing activity are:

- greater responsiveness to the needs of the purchasing department’s internal customers (i.e. other business functions within an organisation) especially in large organisations comprising distinct business segments with disparate purchasing needs and/or multi-site organisations
- reducing the risk of dependence on a limited number of suppliers, which

could potentially result from over-centralisation of purchasing activity.

A decentralised purchasing structure is orientated towards flexibility and responsiveness. It is more suitable in organisations where:

- the purchasing function is well-established
- a robust framework of governance is already in place
- there is potential scope to improve the quality of support provided by a purchasing department to its internal customers through enhancing its understanding of the challenges and priorities of other business functions.

Hybrid

The merits of centralised and decentralised purchasing vary depending on the organisational context and on the appropriate trade-off between the potential scope for greater economic efficiency and the potential risk of reduced flexibility and responsiveness.

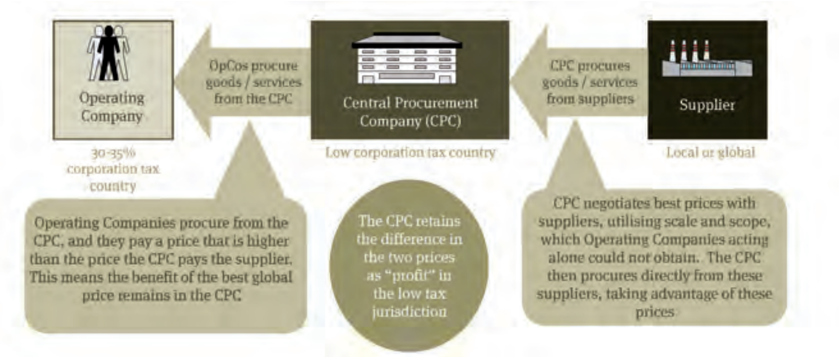
The fact that some organisations operate a centralised structure, others a decentralised structure and others a hybrid approach provides testimony to the ongoing challenge of balancing the purchasing function's key value propositions of effectiveness, efficiency and responsiveness.

Tax efficient procurement company

Multinational companies have complex supply chains with operations in multiple countries. Tax can be due paid in each of these jurisdictions. Rates of corporation tax vary greatly across the world (from approximately 8-40%). For companies who fit the following profile the establishment of a tax efficient procurement company can help to take advantage – legally – of this variation:

- a direct tax rate of more than 25%
- third party expenditure of more than £500,000 per annum
- valuable intangible assets, such as intellectual property, processes and brands
- difficulty in reducing existing supply chain costs
- financial volatility with differing profits by country
- likely mergers and acquisitions.

Tax efficient procurement involves centralising procurement through a company in a location with relatively low corporation tax. Leveraging scale and scope allows the central procurement company to negotiate improved supplier agreements. The procurement company then retains the benefits in the low tax location by charging higher prices (typically in the form of a percentage of expenditure or a service charge) to the operating companies in the countries than it pays to the suppliers. The procurement company must be a material operation – it cannot be a shadow office – with procurement management who are responsible for the supplier negotiations, being based permanently in its location. The physical flow of the goods does not go through the procurement company location.



Trading division

In some cases the establishment of a trading division can help to manage complex, multinational supply chains. Examples of this include European automotive manufacturers looking to set up production facilities in China. In this case there is a tension between needing to balance the introduction of local suppliers, the ongoing expectation for high quality supply and ensuring full tax and duty compliance. The establishment of a trading division helps to provide the necessary governance and control from a pricing, tax and quality perspective.

Outsourcing

An organisation may outsource some of its purchasing processes to a third party service provider. Outsourcing involves:

- evaluating the effectiveness of internal purchasing processes and identifying the potential scope for improvement through outsourcing

- selecting a suitable third party with the appropriate competencies and an established record of delivery
- establishing a robust service level agreement (SLA), which sets out a consistent mutual understanding between both parties on objectives, requirements and expectations
- monitoring the performance of the third party service provider.

Outsourcing can involve one of a number of different approaches:

Incremental approach: an organisation starts by outsourcing some of its purchasing processes to test the capabilities of the third party service provider and gradually outsources more activities as it gains confidence in the capabilities of the provider.

Full outsourcing approach: all purchasing processes are outsourced.

Hybrid approach: transactional purchasing activities are outsourced, but strategic sourcing activities are retained in-house.

Suitability

Outsourcing may be suitable for organisations, which are struggling with problems arising from the ineffective operation of existing purchasing processes and 'maverick buying'. In such circumstances, the role of the third party service is akin to that of a change agent, which can potentially transform and enhance some of the organisation's purchasing activities.

Conversely, if an organisation's purchasing processes are best-in-class and are already delivering a good outcome in terms of effective cost management, compliance and consistency, there is less of a business case for outsourcing.

The potential relevance of outsourcing in tail spend management is considered separately below.

Tail spend management

The concept of tail spend management is based on the Pareto principle, also commonly known as the 80/20 rule. According to the Pareto principle, for many events approximately 80% of the effects are attributable to 20% of the causes. In a purchasing context, 80% of an organisation's suppliers may account for 20% of its aggregate spend.

Tail spend management addresses this 20% of spend. In every organisation a purchasing function will have limited resources and thus has to determine its priorities in terms of spend management. In light of this it may appear to make sense to focus on those areas where the largest impact can be felt, namely the largest spend categories and the most significant suppliers.

Time and resource constraints may lead to managers incorrectly assuming that the effort involved in tail spend management would be disproportionate to its potential benefits and thus omitting to consider such 'non-critical' tail spend. This may, however, be a misconception leaving a tail accounting for up to 20% of expenditure and around 80% of all suppliers, which is neglected. The tail spend can, however, represent the majority of transactions for an organisation and may potentially cover a wide range of products and services.

Tail end spend management can thus sometimes lend itself to outsourcing to a third party service provider.

Potential challenges

The potential challenges of outsourcing include:

- a perception that outsourcing will result in a loss of control of purchasing activity
- internal organisational resistance
- practical difficulties of managing the third party service provider, monitoring its performance and tracking the benefits (if any) of outsourcing.

Potential benefits

The potential benefits of outsourcing are:

- gaining access to improved supplier pricing by leveraging the negotiating power of the third party service provider and thus achieving cost reductions for some goods and services
- gaining access to potentially more intelligence on markets and suppliers
- freeing up the time of purchasing personnel to focus on strategic sourcing activities
- improved visibility of purchasing spend

- reduced transactional purchasing costs.

More information on good organisational design principles can be found in Collinson Grant's sister publication 'Managing organisational design'.

12. Attributes of a great procurement professional

12 Attributes of a great procurement professional

In the past the management of third party expenditure was often viewed as a back office, transactional activity. It now has a strategic focus and therefore the attributes needed to be successful have changed. Here are some.

Seeing the bigger picture

"It's unwise to pay too much, but it's worse to pay too little. When you pay too much, you lose a little money - that's all. When you pay too little, you sometimes lose everything, because the thing you bought was incapable of doing the thing it was bought to do.

The common law of business balance prohibits paying a little and getting a lot – it can't be done. If you deal with the lowest bidder, it is well to add something for the risk you run, and if you do that you will have enough to pay for something better."

John Ruskin

The individual must understand the strategy of the business, the pace of change and how third parties can contribute effectively to it. There is more to life than buying it cheaper.

A focus on facts – the appliance of science

"It is a capital mistake to theorise before one has data."

Sir Arthur Conan Doyle

To rely on influence without data as a buyer is to build your house on sand. When preparing a category strategy, planning for a negotiation or producing a request for quotation you will get ahead by using all the relevant data at your disposal. Once you have the data you can then look to influence your internal and external stakeholders.

Stakeholder management – the art of procurement

"People will forget what you said, people will forget what you did. But people will never forget how you made them feel."

Maya Angelou

For the procurement professional stakeholders span both colleagues and suppliers. The skill for the successful individual lies in establishing effective relationships both internally and externally. This will require a partnership approach in the case of strategic suppliers and colleagues who have responsibility for designing goods and services. In other cases the relationship will be far more transactional. In these cases the challenge is to get what you need without overinvesting time and energy. Good stakeholder management begins with listening, understanding the needs and aspirations of your stakeholders, and then working with them to achieve your goals. To do this requires good influencing skills.

Influencing skills

“The greatest ability in business is to get along with others and influence their actions.”
John Hancock

Understanding the balance of power and where this comes from is vital. Some suppliers gain power and influence from their technical know-how. Others may focus on building lasting relationships with senior stakeholders.

There are several ways to establish and exert influence:

- logic: using data and evidence to support your argument
- use of authority: for example ‘The CEO has asked me to get this’
- using friendship to justify your request
- building a closer relationship by socialising with someone: suppliers will frequently do this
- consulting: asking the other person what they think as a starting point to introduce your idea
- exchange: ‘ if you, then I...’
- using values: convincing someone that the idea is ‘the right thing to do’.

Curiosity

“We cannot solve our problems with the same thinking we used when we created them.”
Albert Einstein

Curiosity is defined as ‘a strong desire to know or learn something. In dealing with third parties the best people are always looking to draw out useful information and insights. In addition, when looking at their categories or areas of responsibility they are relentless in trying to understand why things are the way they are, seeking new and better ways of buying them, which sometimes means new and better suppliers.

Decision making

Timely and effective decision making is critical to the success of any procurement professional. There are typically four elements that will help or hinder this:

- People – who often have their own agendas.
- Information – lack of data can cause people to procrastinate. Equally too much data can present its own challenge.
- Interests – stakeholders may have interests that overlap with the decision to be made, causing them to delay, divert or derail the process.
- Emotions – even if the data support the proposed decision and all the interests have been dealt with, people may still have strong feelings. To achieve a timely decision with the commitment of all stakeholders it may be necessary to deal with the emotions that people have regarding the subject before you can proceed.

It is therefore essential for procurement professionals to learn and develop techniques to handle all of these facets.

13. Summary

13 Summary

Managing third party expenditure well can and will make a massive difference to the profitability of a business. Equally, failing to recognise and manage the risks in its supply chain can destroy an organisation.

Start with the basics:

- what to buy
- when to buy it
- know why you are buying it
- manage the expectations of internal customers
- how you will organise your resources to provide best value
- what processes do you need to master
- what technology will you use to produce valuable data analysis and to enable and accelerate these processes?

These things provide the basis for developing a strategy for managing third party expenditure, one that takes account of inputs, throughputs and outputs - and is aimed at maximising the return on investment of time and effort. The way in which different elements of a purchasing strategy should be defined and their relative emphasis depend, however, on the relevant organisational context.

Two core processes underpin good third party expenditure management. Strategic sourcing aligns an organisation's purchasing activities with its business strategy and aims to manage cost and enhance supplier performance, as well as minimise supply chain risk. Transactional procurement sustains the robustness of an organisation's day-to-day purchasing activities. Enabling technology increasingly supports both of these core processes.

Optimising an organisation's supply chain involves achieving an appropriate balance between ensuring sufficient competition and minimising administrative complexity. The optimal number of suppliers needs to take account of its situation, strategy and operating model.

An organisation's purchasing activities need to be underpinned by an effective governance framework. This should include an organisational structure for decision-making, as well as appropriate policies, procedures and internal controls. The most appropriate organisational model for purchasing activity will, however, vary depending on the trade-off that an organisation seeks to achieve between the potential scope for greater economic efficiency and the possible risk of reduced flexibility and responsiveness, and on its perception of the relative balance between the purchasing function's key value propositions of effectiveness, efficiency and responsiveness.

An effective purchasing professional needs to have a diverse skillset. This involves an ability to see the bigger picture, to focus on relevant data, to manage different stakeholders, to influence, a desire to learn and improve, and a readiness to make timely and difficult decisions.

At the heart of any great procurement organisation, you are likely to find a relentless focus on four cornerstones of:

- skills and capabilities: helping people to be the best they can at managing third party expenditure
- a clear, effective and well aligned organisation
- process mastery, including getting the best from suppliers
- technology: providing insight, efficiency and automation, helping get to grips with data.

14. About Collinson Grant

14 About Collinson Grant

Collinson Grant is a management consultancy. We help firms all over Europe and worldwide to restructure, merge acquisitions, cut costs, boost performance and profit, and manage people. This builds long-term relationships. We have kept some clients for over 40 years. Our emphasis is on results and value for money. We expect to give a first class return on the investment in us. So we do not recommend action unless we are sure that the outcome will be worth it. We are not afraid to give bad news, or to champion ideas that may not be welcome.

Skills – the sort of work we do

Most of our work is on three themes – organisation, costs, and people. We use this simple framework to manage complex assignments – often with an international dimension – and to support managers on smaller, more focused projects. We help them:

- to restructure and integrate – following acquisitions or to improve profits
- to rationalise the supply chain – we examine every process and interface to improve efficiency and service
- to set up financial and managerial controls – we create robust systems to improve decision-making and reduce risks
- to introduce Lean manufacturing and refine business processes – we analyse and improve how work is done, and use new ways to create change and make it stick
- to cut costs – we make systematic analyses of overheads, direct costs and the profitability of customers and products; this helps managers to understand complexity, and to take firm steps to reduce it
- to fill short and longer-term managerial gaps by supplying skilled and experienced interim managers
- to manage people – we draw up pay schemes and put them into effect, guide managers on employee relations and employment law, get better performance from people, and manage redundancy.

Our consultants have held senior executive line positions with responsibility for profit and loss. We work in many different sectors for large private and public companies and also in the public sector.

15. Notes on quotations

15 Notes on quotations

This publication contains selective quotations. Here are some brief introductions to the persons quoted.

Page reference	'Famous person'
1	Aristotle (384 BC - 322 BC) was an Ancient Greek philosopher, who laid much of the groundwork for Western philosophy. His writings, which covered many subjects, represented the first comprehensive system of Wetern philosophy. Aristotle was also the tutor of Alexander the Great.
1	Marcus Porcius Cato (234 BC - 149 BC), also known as Cato the Elder and Cato the Censor, was a Roman soldier, statesman, author and orator. He became well-known for his stern morality, oratory and writing on moral and political issues, as well as his antagonism to Greek influences in Roman society.
1	William Feather (1889 - 1981) was an American author and publisher. He was best known as the editor of The William Feather Magazine and as such he established a national reputation in the United States as a 'benevolent iconoclast'.
2	Ray Kroc (1902 - 1984) was an American businessman and philanthropist. He built McDonald's into the most successful fast food business in the world and was credited with a number of innovations in the food service franchise model.
7	Sun Tzu (544 BC - 496 BC) was a Chinese general, military strategist and philosopher. He wrote The Art of War, which sets out a philosophy for managing conflicts and winning battles. This is regarded as a masterpiece on strategy and has been read and referred to by many generals and thinkers since it was first published and translated.
8	Michael Porter (born 1947) is an American academic best known for his theories on business strategy and economics. He is the author of numerous books including Competitive Strategy, Competitive Advantage, The Competitive Advantage of Nations, and On Competition. In addition to his academic

research, writing and teaching, Porter has served as an advisor to business, government and the social sector.

9, 94 Albert Einstein (1879 - 1955) was a German-born physicist, who settled in the United States. He developed the general theory of relativity, one of the pillars of modern physics, and was awarded the Nobel Prize in physics in 1921. Einstein's intellectual achievement and originality have made his name synonymous with genius.

10 Louis Pasteur (1822 - 1895) was a French chemist and microbiologist. He carried out extensive work in the field of vaccination, but is probably best known for his invention of the technique of treating milk and wine to prevent bacterial contamination, a process now referred to as pasteurisation. He is also regarded as the 'father of microbiology'.

11 Winston Churchill (1874 - 1965) was a British statesman, who was the Prime Minister of the United Kingdom from 1940 to 1945 and from 1951 to 1955. He is widely regarded as being one of the most influential people in modern British history. In a poll conducted in 2002, Churchill was ranked the Greatest Briton of all time.

36 Ivan Glasenberg (born 1957) is the chief executive officer of Glencore, one of the world's largest commodity trading and mining groups.

38 Bill Gates (born 1955) co-founded Microsoft, which went on to become the world's largest PC software company. Later in his career, Gates became a philanthropist. He has donated to various charitable organisations and scientific research programmes through the Bill & Melinda Gates Foundation, which was established in 2000.

38 Kaoru Ishikawa (1915 - 1989) was a Japanese organisational theorist. He is best known for the Ishikawa or cause and effect diagram (also known as fishbone diagram), which is often used in the analysis of industrial processes.

39 Abraham Maslow (1908 - 1970) was an American psychologist. He is best known for creating Maslow's hierarchy of needs,

a theory of psychological behaviour that prioritises the fulfilment of different innate human needs, culminating in self-actualisation.

44 Napoleon Bonaparte (1769 - 1821) rose to prominence during the French Revolution and later became Emperor of the French from 1804 to 1814, and again in 1815. Napoleon was one of the greatest military commanders in history and led France against successive coalitions of other European states in the Revolutionary and Napoleonic Wars. Through his successful military campaigns, he established a large empire that ruled over much of continental Europe before its final collapse in 1815. Napoleon's legacy has cemented his status as one of the most influential but also controversial leaders of all time.

45 Carly Fiorina (born 1954) is an American businesswoman and politician. She is known mainly for her tenure as Chief Executive Officer (CEO) of Hewlett-Packard (HP) from 1999 to 2005.

93 John Ruskin (1819 - 1900) was a leading English art critic, social thinker and philanthropist during the Victorian era. In 1869, he became the first Professor of Fine Art at the University of Oxford. Ruskin wrote very extensively, initially in the fields of art criticism and history, but later covering a wide range of topics including science, geology, ornithology, literary criticism, the environmental effects of pollution, political economy and social reform.

93 Sir Arthur Conan Doyle (1859 - 1930) was a Scottish writer and physician, most famous for creating and writing stories about the fictional detective character Sherlock Holmes. He was a prolific writer and his other works included fantasy and science fiction stories, plays, romances, poetry, non-fiction and historical novels.

93 Maya Angelou (1928 - 2014) was an American poet and civil rights activist. Her most famous works - which focus on the themes of identity, family and racial discrimination - have been characterised as belonging to the distinctive literary genre of autobiographical fiction.

94 John Hancock (1737 - 1793) was an American merchant and statesman. During the American Revolution, he was president of the Second Continental Congress when the Declaration of Independence was adopted and signed.

16. Glossary of terms

Category management	The range of products purchased by an organisation is analysed into distinct groups of similar or related products - known as product categories - to identify the optimal approach for each category.
Centralised purchasing model	An organisational design in which a single department of an organisation makes all (or most) of the purchasing decisions for all of its functions and business units.
Conflict of interest	An actual or potential situation in which the personal interests of an employee are or appear to be at odds with those of the employer.
Country of origin	The country in which goods are manufactured.
Currency option	A financial instrument that provides the holder with an option to buy or sell a specified amount of foreign currency within a specified period of time at a predetermined exchange rate.
Decentralised purchasing model	An organisational design in which purchasing decisions are mostly made by each function or business unit within the organisation.
ERP system	A software system designed to manage most or all aspects of a manufacturing or distribution operation. ERP systems usually comprise modules - such as purchasing, inventory management and sales - that are designed to work seamlessly with the other modules in the system.
Forward contract	A financial instrument that involves the purchase or sale of a specified amount of foreign currency at a specified future date based on a predetermined exchange rate.
Hybrid purchasing model	An organisational design that has elements of both centralised and decentralised purchasing.

Incoterms	Commercial terms defined by the International Chamber of Commerce (ICC) and widely used in international commercial transactions and purchasing processes. Incoterms are intended primarily to set out the respective responsibilities and risks of the supplier and the customer in the transportation and delivery of goods.
Lead time	The period of time from the date of a purchase order to the date of delivery including time required by the supplier to manufacture the item ordered and to make it available for shipment.
Life-cycle costing	A costing methodology that considers the total cost of ownership comprising the cost of acquiring, operating, maintaining and (if relevant) disposing of an item.
Pareto principle	A principle that for many events approximately 80% of the effects are attributable to 20% of the causes. It is also known as the 80/20 rule.
Porter's Five Forces model	A framework developed by Michael Porter that attempts to analyse the competitive intensity, potential profitability and thus attractiveness of an industry sector. The five forces, that purportedly affect an organisation's ability to serve its customers in an industry sector and generate a profit, are (a) the threat of new entrants (b) the potential availability of substitutes (c) the bargaining power of suppliers (d) the bargaining power of customers and (e) the level of competition in the sector. A combination of these five forces may constrain profitability making an industry sector less attractive.
Product teardown	This involves disassembling a product to identify its component parts, understand

their functionality and determine costing information.

Purchase order	A document provided by a customer to a supplier that sets out the terms and conditions of a proposed purchase transaction including a description of the requested item(s), quantities, delivery schedule, terms of payment and transportation.
Purchase requisition	A document generated internally within an organisation by a user department that notifies the purchasing function of what it needs to order, the requisite quantity and the timeframe. It may also provide appropriate authorisation to proceed with the purchase.
Purchase to pay cycle	A sequence of activities carried out by an organisation in purchasing goods and services from external third parties. This is also known as 'Transactional procurement'.
Reciprocal trading	A situation in which being a customer of an organisation is a condition of being a supplier. This is also known as 'countertrade'.
Source to contract	A purchasing philosophy and strategy that emphasise a cycle of continuous improvement and an ongoing re-evaluation of an organisation's purchasing activities. It typically involves (1) Analysing purchasing needs and the potential supplier market (2) Developing a sourcing strategy (3) Engaging the supply market (4) Requesting suppliers to quote (5) Negotiating a supply contract (6) Implementing the contract (7) Monitoring supplier performance. This is also known as 'Strategic sourcing '.
Strategic sourcing	See 'Source to contract'.

Supplier imposition	A situation in which a customer specifies that an organisation should use a particular supplier.
Tail spend management	This concept is based on the Pareto principle (80/20 rule) and involves addressing the 20% of an organisation's expenditure, which may account for 80% of its suppliers.
Transactional procurement	See 'Purchase to pay cycle'.
Value analysis	A process which assesses a product to compare its function with its cost. This can be used as an tool for cost management and reduction.

Collinson Grant

Costs	**People**	**Organisation**
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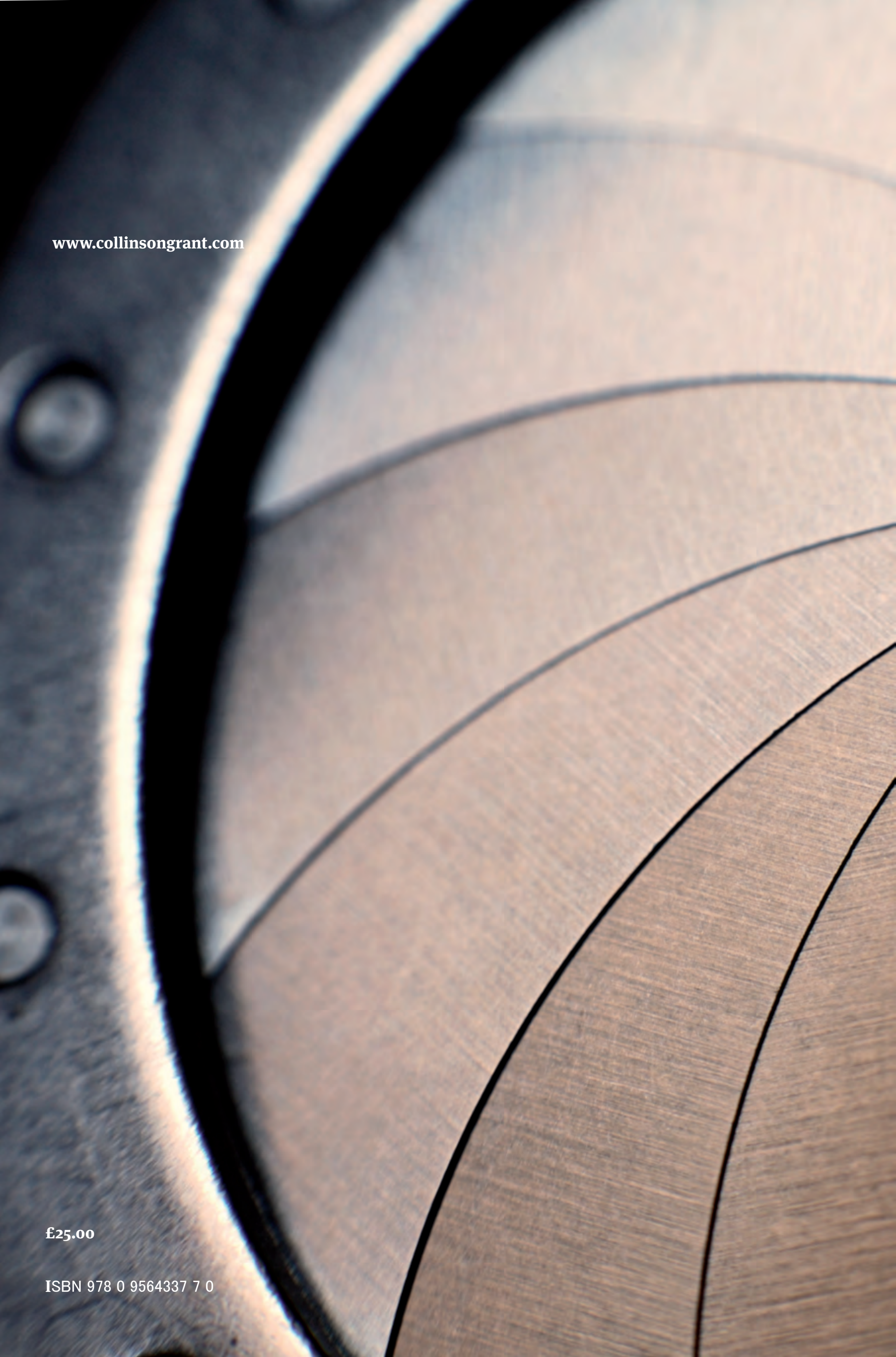

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