strategies for cutting costs

TURNING PROCUREMENT INTO A VIRTUOUS CYCLE

BY PAUL TER WEEME

Chief financial officers and chief procurement officers at *Fortune* 500 companies are facing a dilemma. They've cut millions of dollars to create organizations that are running leaner than ever, but, as the timing for an economic turnaround remains uncertain, many have to reduce spending still more.

While the obvious answer to improving overall financial performance can be found in attracting new customers, reducing the cost of goods, and cutting operational costs, many executives might be surprised to learn that analyzing and controlling the cost of indirect goods and services can provide significant savings opportunities.

Most companies are adept at managing their direct spending, but when it comes to the indirect procurement process, there's a lot of inefficiency. Indirect spending represents between 20% and 30% of a manufacturing company's expenditures and 40% and 50% of those of a service company.

By applying principles used when managing direct spending, even the best-run *Fortune* 500 companies can cut indirect spending by 10% to 30%.

As the pressure to cut costs continues, many companies are finding that a hybrid solution involving specific, deep intelligence across a wide range of indirect spending categories and powerful technology can offer the way to save money without harming the business.

BREAKING THE "VICIOUS CYCLE" OF PROCUREMENT

There's no question CFOs can cut costs once they understand how to evaluate their company's indirect spending. But the key is turning procurement from the current vicious cycle where decisions are made without critical understanding about where and how much is spent with vendors into a virtuous cycle where good information generates better decisions.

In many companies, 20% of transactions on negotiated contracts—maybe less—are in compliance with procurement policies (i.e., right vendor, right specification, right price), but CFOs can't fix the situation and capture any savings because they don't have the necessary information. To break out of this trap, they need to be able to answer three simple questions:

1. Are we buying from the "right" vendors?
2. Do we have airtight best-in-class agreements in place with each vendor?
3. Are employees consistently buying in line with these agreements?

Understanding the answers to these questions is a critical first step in establishing and enforcing company-wide initiatives to adhere to the agreements made with key vendors. Without them, too much money is being spent on indirect goods.

STEP ONE: KNOW YOUR VENDORS

Sourcing is the stage in which vendors are identified, selected, and engaged, making it a critical step in the procurement cycle. A successful sourcing strategy requires access to purchasing information across the organization and the ability to act on it.

This means understanding from whom the company is buying, how much is spent with each vendor, which vendors offer rebates, what the terms of the contracts are, and more. It also means benchmarking the company's purchasing operations against industry-published best-in-class standards to truly drive strategic sourcing agreements with vendors. Unfortunately for CFOs, getting this information is often a challenge since the data usually resides in disparate general ledger, accounts payable, and enterprise resource planning (ERP) systems. In addition, the data in these systems is difficult to mine, and matching up transactions can be a painful, tedious process.

In addition to information, financial executives need systems to identify appropriate vendors, drive spending to those vendors and measure performance across the organization, and develop incentive programs to maximize the value and service from top vendors.

STEP TWO: SIGN ON THE DOTTED LINE

Sourcing delivers dramatic savings by securing tight contracts with the vendors that best meet your company's needs.

The key to designing optimal contracts is to know how to ask for and analyze prices in a way that mirrors how vendors think about business. For example, when buying contingent labor, vendors currently provide an integrated bill rate. This is the wrong approach for companies. CFOs need to see costs based on the split between the payment that the actual temporary employee receives, the markup for government statutory payments, and the pure markup that the placement agency keeps. In addition, each price component is driven by a different cost structure. Within the temporary employee category, there are distinct markets for the discrete parts of the process: a local market that drives the actual wage cost of the employee, a separate market for the cost of finding the employee, a separate one for processing payment to them, and so on. Each cost center within the category needs to be negotiated separately to reflect the different dynamics of each of these "markets."

Many companies have learned to manage direct spending extremely well. They now need to apply those lessons to indirect categories such as IT labor, commercial printing, media, computing, freight, healthcare, office supplies, and the like. These are complex categories; they also have the deepest impact in terms of generating bottom-line savings. As illustrated above in the example on sourcing IT labor, in order to achieve maximum savings in these categories, it's imperative for the sourcing team to have deep category intelligence and a keen understanding of the elements that drive pricing within each unique category.

Sourcing complex categories presents a unique analysis challenge. Requests for proposals (RFPs) aimed at developing contracts can generate tens of thousands of data points that need to be organized, analyzed, and compared against the level and type of spending. A company has to identify exactly the level and source of savings, but most negotiations on price don't adequately allow for the need to look at what the true bottom-line impact is once the mix of purchases is taken into account. Companies need contracts that can handle the many permutations and combinations of what may be purchased in each category. And they should provide the option of going to market on an ad hoc basis as required to secure potentially lower prices.

STEP THREE: ENFORCE COMPLIANCE

The tightest contracts can't help a company if employees are working around the system. One of the greatest sources of money loss comes from employees who don't buy according to the contracts every time they make a purchase. Companies need to provide a purchasing environment that's easy to access and use where hard-won contract pricing is automatically applied to every purchase. In cases where each category has multiple buyers across the organization, immediate enforcement is crucial.

Theoretically, contract enforcement exists in more advanced business process solutions such as ERP systems. In general, however, these systems aren't flexible enough to recognize unexpected changes in the conditions of delivery that would affect ongoing costs for the rigorous compliance needed for managing the complexities of indirect spending. For example, security services may be provided at an hourly rate, but a spike in fuel costs could result in a surcharge. Unless this potential additional expense was captured in the discovery phase, it's unlikely that it would be flagged as potentially outside the bounds of the contract terms by most of today's business process systems.

Beyond embedding contract pricing, a system needs to give buyers the freedom to bid out each job to a preferred vendor set using the contract price as a ceiling while allowing vendors to bid lower based on availability and desire to win the job. Automated procurement systems aren't just about workflow management and approval authorizations; their primary purpose is to enforce and manage price and nonprice components such as quality, delivery, and flexibility. Training all users and preferred vendors on how the new system works and how using that system benefits them will make sure they comply with the company's purchasing policy.

Once all purchasing is automated and centralized, CFOs can monitor the indirect spend that has been sourced, measure compliance of employees and vendors, and watch the savings pile up.

the path to spend management

There is a lot of money on the table to be saved by looking at indirect expenditures: Addressing the entire indirect procurement cycle can save a company more than 20%. Companies can expect greater demand from shareholders for improved earnings per share, and it's not going to come from the top line.

The bottom line is that, for companies experiencing the squeeze of cost reduction initiatives, the path to spend management is clear:

- Ongoing visibility into spending data in terms of an integrated, corporate-wide view of procurement activity.
- Clearly defined ownership of spend categories in terms of distributed and centralized hierarchy for categories that makes the most sense for the organization.
- Established goals for spending reduction and rewards and sanctions tied to those targets.
- Robust monitoring infrastructure.
- Scorecard system for communicating progress on goals.

TECHNOLOGY TO THE RESCUE?

Sourcing tools such as procurement portals or reverse auction offerings are of particular interest in today's market. There are a number of strong technologies available, but they address only one aspect of the procurement cycle: facilitating the actual transaction. The real challenge with many of these solutions lies in the lack of baseline intelligence and rich vendor data needed to truly understand the myriad of nuances and layered complexity related to indirect spending that makes it possible to maximize return on the sourcing effort.

Analytics solutions offer another approach to tackling the challenges of reducing indirect spending. Effective procurement-oriented data analysis is the backbone of successfully exerting full control over a company's procurement cycle. True financial management calls for unusually deep insight into corporate data for time-specific, vendor-specific, event-specific price and quantity information. To determine if a company is benefiting from the best terms in the marketplace, CFOs also need solid information about the prevailing market. Combined, these requirements represent an enormous database problem—one that's clearly beyond the capacity of most of today's corporate data warehousing platforms.

A BLENDED SOLUTION IS THE ANSWER

The best way to tackle spend management is to address the complete procurement cycle through a combination of technology, category-specific content, and expert services. With these three aspects of the procurement solution working in concert, companies can maximize savings and dramatically reduce the amount of time it takes to see a return on investment.

Robust technology and category content are imperative. The most beneficial outcomes result when a qualified procurement professional with commodity-specific expertise is running the analytics and sourcing programs to drive the direction of the spend-management process.

To create a procurement cycle that drives dramatic improvement in speed, accuracy, and impact and ensures ongoing savings, companies should look for:

◆ Analytics solutions designed specifically to aggregate, organize, and normalize the multidimensional procurement transaction data. These systems must also be easy to refresh as data evolves.

◆ Sourcing technology that automates high-volume bid collection, management, and analysis. This technology, coupled with the right information, can cut the time it takes to identify, engage, and begin to monitor results from vendors by more than 50%.

◆ Accessible Web-based software that enables and enhances the day-to-day purchases of even the most complex indirect spend. This system must have contract pricing embedded to set pricing ceilings and have highly detailed and customizable report templates that can be used to facilitate in-depth monitoring.

Beyond technology, rich content in the form of detailed vendor profiles, industry best practices, and benchmarked price data is also required to take full advantage of the possible savings in each commodity. In the analytics area, vendors must be properly categorized so finance can get an accurate depiction of what is being spent with each vendor. Automating this process with existing rich vendor family designations is key. Tools that allow rule tracking greatly reduce the "hands-on" effort in terms of capturing and interpreting this detail and are a valuable addition to the effort to streamline the procurement process.

To automate sourcing, deep category intelligence is required, not only for building meaningful RFPs but, more important, for the back-end analysis of the tens of thousands of data points that come back into the system. Building this type of category intelligence to sit on top of sourcing technology makes it possible to ask the right questions based on the unique product or service being sourced, analyze those tens of thousands of data points, qualitatively choose the best vendors, and design the most effective contracts.

For many companies, the costly engagement cycles that come with traditional consulting offerings for full spend management are prohibitive. At the same time, it is increasingly becoming clear that the complexities of finding and ensuring the best possible supplier results can't be resolved with automated tools. A new breed of solutions providers is emerging that brings both the deep category-rich content and intelligence and best-of-breed optimization technology to help companies achieve greater savings for significantly less money and in less than half the time.

GETTING MORE WITH LESS

In this economy, it isn't easy to be responsible for an organization's fiscal well-being. Indirect spending may very well be the final frontier for cost efficiency. Armed with intelligence about where and how money is spent, financial executives can assess spending and put initiatives in place that ensure their organizations are buying from the best vendors and getting more from them.

The companies that wrangle these costs with a combination of technology, intelligence, and a little help from the experts will find that there are ways to get more savings out of the organization without making it impossible to continue to do business. ■

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