The CFO's Best Friend

Purchasing isn't just a supply chain activity—it's a value-adding market activity that can make a significant contribution to profitability.

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Many companies have long recognized the importance of cutting costs to become globally competitive. Consequently, organizations have put more emphasis on their supply chain activities, including purchasing. Everyone knows that if you spend a dollar less on purchasing, it goes right to the bottom line. The chief financial officer (CFO) and most other senior executives understand that if their company could cut the cost of all goods and services purchased by just 1% or 2%, it would have a substantial positive impact on profits. That's why many, if not most, companies have put a functional leader in place with the title of "Purchasing VP." To some extent, many companies have consolidated their supplier base by centralizing and aggregating the critical "buys" and assigning them to strategic purchasing teams. As a result, these companies feel they've addressed the opportunity adequately. So, the job is done—or is it?

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Here's the simple question that few organizations can answer: *When purchasing, do we have the most competitive price in the market?* The corollary question is: *When purchasing, did we "test" the market to determine if we had the most competitive price?* The answers to these two questions determine the degree of impact that procurement has on overall competiveness. The scope of opportunity for improvement can be significant because many CFOs consider purchasing to be an underperforming unit. In fact, a recent report by the Aberdeen Group estimates that less than 20% of CFOs "view procurement's impact on overall competitiveness as very positive." A major improvement in this area and the consequent impact on profitability could make the chief procurement officer (CPO) the CFO's best friend.

In many organizations, the value of the total cost of purchased goods and services is often larger than the value of any individual business unit, but the subject of "effective and competitive" purchasing doesn't regularly make the agenda of the executive team. Yet with executive committee focus and aggressive buy-side market testing, purchasing can become a competitive advantage. The scope of opportunity for purchasing-driven profitability to make a significant incremental contribution to the bottom line is considerable for most companies.

Table 1 depicts the scope of impact on the bottom line for two representative companies on reducing the total cost of purchases, assuming that all other factors remain constant. In the situation at Company A, the total value of purchased goods and services is assumed to be 40% of revenues, earnings as a percent of sales is assumed to be 3%, and the positive impact on the bottom line based on reducing the total cost of purchases by just 5% is 66%. In the situation at Company B, the percent of revenues of purchased goods and services is assumed to be 60%, earnings as a percent of sales is assumed to be 5%, and the percent improvement to the bottom line based on reducing the total cost of purchases by just 5% would be 60%. Generally, a 5% reduction in the total cost of purchasing goods and services (all other factors remaining constant) may produce an improvement to the bottom line of anywhere from 28.5% to 100% for the typical company, depending on the specific circumstances. This potential, if realized, would bring a smile to the face of even the most cantankerous CFO.

The unfortunate truth, however, is that many senior executives think purchasing is a mechanical, necessary part of the supply chain rather than a value-adding "market activity" that can make a substantial contribution to the company's profitability. To find out how your company is doing, take the "purchasing challenge" test shown in Table 2. It only takes a few minutes.

THE PURCHASING CHALLENGE: A SELF-TEST

Table 2 outlines the major factors to consider and provides the means for a self-assessment.

If you answered "FALSE" to three or more of the state-

Table 1: Earnings Impact: The Scope of Opportunity

	COMPANY A	COMPANY B
The value of all purchased goods and services as a % of Sales	40%	60%
Earnings (EBIT) as a % of Sales	3%	5%
% improvement in Earnings (EBIT) by reducing the overall cost of purchased goods and services by 5%	66%	60%

Table 2: Assessing the Scope of Opportunity

FACTOR	TRUE	FALSE
The purchasing organization sets criteria such as reliability of supply, quality, and on-time delivery as prerequisites for being accepted as a supplier.		
We have centralized the purchasing of all key products and services such that the same or similar product or service is not purchased by different decision makers across the company.		
The senior purchasing people are clearly of the same caliber as their peers in sales, marketing, R&D, finance, and information systems.		
The purchasing people use a team-based approach with key resources from the appropriate business unit, manufacturing, and technical services to supplement their purchasing team on all critical buys.		
We understand our suppliers' cost structures as well as they do.		
We have the right data to identify the opportunity for purchasing-driven profitability.		
The purchases of goods and services are "tested" for the best price on the buy side in the same way as our sales organization continuously tests the market on the sell side.		
The purchasing team establishes enduring relationships with key people in the suppliers' organizations on the buy side just as well as is done on the sell side.		
The training program for purchasing managers is at least on par with what we systematically do for sales managers.		
Purchasing is seamlessly connected to an end-to-end supply chain process such that procurement of product, delivery, use, replenishment, and inventory control are in a single, integrated process.		
The chief purchasing officer is on par with his/her peers on the executive committee.		
The chief purchasing officer is part of our most senior management body—often called the "executive committee"—or at a minimum has a regular agenda item on executive committee meetings.		
Business units value the contribution made by purchasing and regularly invite the appropriate purchasing manager to participate in business meetings.		
The senior purchasing executive has been clearly tasked by the CEO and CFO with making a specific, measureable contribution to profitability.		

ments in Table 2, then your company could have a major opportunity to improve its purchasing practices. The extent of your success will depend on how much executive attention the CFO and CPO bring to these opportunities and the amount of organizational energy they invest.

While the most important "missed opportunities" in purchasing today are "market testing" and "executive focus," much more is involved, including, but not limited to, the mental model and behaviors of your purchasing team, the extent you understand your suppliers' cost structures, the caliber and development of the people on the buy side, and assuring that purchasing is seamlessly connected to an end-to-end supply chain process so that procurement of product, delivery, use, replenishment, and inventory control are in a single, integrated process.

EXECUTIVE FOCUS IS CRUCIAL

It all begins with executive focus and attention. The CFO can play an essential role in laying the right framework for the CPO in this respect. We know that the key activity areas for manufacturing companies are to design, buy, produce, sell, and distribute goods. If you accept the proposition that the value of the total cost of purchased

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goods and services is larger than any individual business unit, then ask yourself these two questions: *How many hours a month does the executive team spend talking about individual business unit sales and marketing issues, reviewing sales data, market share, key accounts, etc.? How much time is spent reviewing the reciprocal data on the purchasing side?*

Now look at the agendas for the past year or two to determine how many hours were devoted to strategic purchasing, competitive acquisition of goods and services, purchasing profitability contribution, and other related practices. For many companies, the ratio is 5 to 1, or 25 to 1, or maybe the attention devoted to purchasing by the executive committee is so small that it isn't even meaningful. What is it for your organization? The best way to elevate the buy-side issues to the executive committee level is to have the senior purchasing officer (the CPO) sit on the highest decision-making body in the company or at least have a regular time slot on the executive committee meeting agenda to put the relevant buy-side business issues on the table. This is where the CFO can partner with the CPO in framing these issues in clear financial terms.

A STRONG CPO

Given adequate executive focus, the caliber of the purchasing team, their mental model, and their business practices will determine the degree of success an organization can realize in assuring that purchasing makes a significant contribution to overall profitability. First, the CEO and CFO need to reach agreement on the value of having a powerful chief purchasing officer. Typically, to put the right executive in place as the CPO involves taking a high-profile person, with a sales/marketing or a Strategic Business Unit (SBU) leadership background, and putting this person (with weight and influence) in charge of procurement. This individual should have a strong, historical track record of success in line management, a passion for getting results, a deep understanding of your business or industry, senior sales experience, and the ability to go toe-to-toe with other members of the executive committee. The CEO, CFO, and this new CPO will then jointly agree on a goal with respect to the incremental improvement in the bottom line that will be driven by purchasing. The CEO and the new CPO will jointly create an environment such that when this person enters a room, everyone knows that they have to pay attention to him or her—like it or not. There are very few companies in the United States who have such a person as their current chief purchasing executive. Does your organization?

The CPO then needs to have a capable, performance-oriented purchasing team. This is a team of people who believe that:

- Key suppliers must demonstrate "a priori" their commitment to quality, on-time delivery, reliability, long-term commitment, ethical behavior, etc.
- All key buys such as raw materials, inbound and outbound logistics, and energy, including items such as capital purchases, laptops, and key services such as contract labor, should be centralized, consolidated, and managed strategically.
- A team approach on the buy side, involving key people from the relevant departments and business units, is just as important as it is on the sell side.

But mind-set or attitude alone isn't enough. The CPO and the purchasing team need to have the right knowledge and set of skills that will earn the respect of people throughout the organization and enable an effective team approach to gather better data on suppliers' costs than you have ever had before through tight collaboration with IT resources. They also need the measurement and management skills to connect the supply chain processes of the supplier to those of the purchaser—and focus on the elimination of waste and cost in the entire supply chain, eliminating errors and driving inventory control. These skills don't come easily. Ask yourself this question: *Has your organization invested in the development of your procurement team members to the same extent that you have in the development of your sales team?*

MARKET TESTING

Now let's consider the key principle of "market testing" on the buy side. When it comes to purchasing, this is a relatively simple, but frequently unapplied, principle of marketing dynamics. Think of it as the mirror image of "testing the market" on the sell side. In general, to determine if your selling organization has extracted the maximum value proposition from the marketplace, the selling organization increases price until this has an adverse effect on sales volume to such an extent that it decreases total revenue or market share. Using this method, the sales organization can defend its position that it has extracted the maximum value proposition available during any given set of market conditions. Likewise, the same mentality can and should be brought to the table when purchasing.

It's interesting to consider that when purchasing or selling, the parties involved are at the same table, but often with two very different mandates. The seller is most likely trying to get the maximum price without losing volume. The purchaser at the table is often willing to accept a "fair price" as long as an extensive laundry list of supply chain criteria is met, such as quality, on-time delivery, reliability, long-term commitment, ethical behavior, and more. These supply chain criteria are important, but they shouldn't be an excuse to pay a premium. The buy-side organization should assess, determine, and qualify those suppliers who can meet the supply chain criteria and then "test" these sellers' willingness to supply in the same way that many sales and marketing organizations test the market—i.e., by the impact on volume. Testing the selling market to determine the volume available should be done aggressively to the point that suppliers refuse to sell. Only when the buyer has "tested" the market and determined the seller's "no sell price" can the buyer know that they've found the bottom of the market. Only by knowing the market bottom and backing off it slightly can the CPO demonstrate to his or her organization that the most competitive buying price in the market has been obtained. This is precisely what CFOs need to encourage.

It goes without saying that there are many buy/sell relationships—some with true partnership components that share profits or those that involve special agreements such as takeout agreements—that don't lend themselves to this approach. But much of what's purchased today could be obtained at a more cost-competitive price if a "buy price/available volume" test were used. And this doesn't just apply to the most important raw materials purchases. It applies equally to all key purchases of both products and services, such as IT equipment, software, contract labor, etc. Only by applying market testing on the buy side with the discipline outlined above can a company optimize the potential contribution of purchasing to overall company profitability.

5 Tips for Getting Started

1. The CEO and CFO agree on the value of having a powerful CPO and take action to put the right person in this role.

2. The CEO, CFO, and CPO jointly agree on the incremental contribution to profitability to be made by purchasing.

3. The CPO assembles an action-oriented purchasing team and identifies the top priority areas of focus.

4. The CPO and the purchasing team take the set of actions needed for success and, in particular, implement "market testing."

5. The CFO and CPO work together to maintain executive attention on the company's progress on achieving the target incremental contribution to profitability.

WHERE TO START

How does this journey begin? Consider the following story of one purchasing executive.

When we started on this program, we had to capture the imagination of senior management that there was an opportunity for purchasing to make a major contribution to profitability. What we said was that if we're purchasing $5 billion of stuff and we cut the cost of purchasing by 5%, then we would make a contribution of around $250 million. But we also said that we're not going to be so foolish as to stand up here and promise you such a large sum of money at the beginning, so our first target was $50 million.

We are going to go and kill elephants first. We did a typical Pareto. Out of the $5 billion, the biggest category was raw materials at around $3 billion. Then we took all the buys of $100 million or more and said we could work out the math later. So we built the list, and the top 10 or 20 products represented around 80% of the total. Then we had something that was very bite size, and we could get our minds around it. Of these top 20 or so, the top two or three were the ones we were going to go after first because we had very large purchases in a bunch of different locations, and they were being handled by different people. So we went to each of those locations and told the people: "Guess what—you don't do this anymore. This now will be handled centrally, and here's why. We will have one standardized, aggregated, and leveraged buy, and one person will be in charge." For example, we took all raw material feedstock purchases and put the purchasing responsibility under one individual who reported to the CPO, and we also took all major IT purchases, including hardware and contract labor, and put the purchasing responsibility for these items under one individual who reported to the CPO.

But we got a lot of pushback. Some of the people who previously had the responsibility for purchasing locally were very unhappy. I explained that we still needed them desperately because each of them had all the critical information, so they weren't out of a job. Their new job would be to support the global negotiation, and they would be on the global negotiating team. But in the future there would be only ONE outside spokesperson who could look suppliers in the eye and say, "If you want to take your business from X to 5X—you have the opportunity—all you have to do is cut the price by Y." We figured out what the suppliers' actual costs were—in a very detailed engineering analysis (raw materials, capital costs, conversion costs)—and what their profitability was—so that we knew when we asked them for a price, we knew how much we were leaving them and that it would be sustainable for them, but it would be a significant reduction to what we were paying them at the time—at least that was our suspicion.

Of course we found in a few cases that there simply wasn't a lot of margin available. But in most cases we were paying somewhat of a premium. The research was actually fairly easy. We had some pretty sophisticated engineers who could drive by a plant and get capacity statistics, etc. The whole idea was that we were going to know more about our suppliers than the suppliers knew about themselves. That was a big mind-shift, and it allowed us to aggressively "test" the market on the buy side. We saw that information is power, and we needed the right mind-set and the right carrot so that when the supplier's sales guy left, he understood that if he gives you the right price he can double his volume with you and maybe even justify expansion of his own business. In the end, every company wants to grow. What you are leveraging is the profit motive on their part. And even if the supplier can't take all the business at that point in time, they can see that in future years it would be an opportunity to grow their business as a key supplier. That's why our suppliers were also interested in engaging with us in tough but fair negotiations.

While we began with modest goals, by the end of our first year we exceeded the $50 million target, and by the end of three years we exceeded the contribution to profit target of $250 million.

WHAT ABOUT YOUR COMPANY?

You determine the size of the prize. Is purchasing worth focusing on? If so, the effective change management implied and performance measurement practices in Table 2 are necessary, and these must be executed with tenacious determination. The CPO needs to ensure that purchasing takes advantage of a team-based approach, engaging some of the best resources from business units, manufacturing, quality, technical services, and other departments. The culture of the purchasing team needs to be shaped such that there's a continuing focus on testing the marketplace for the best price, and this means assuming a certain degree of risk. The entire end-to-end supply chain process needs to be measured and managed in order to deliver the targeted contribution through purchasing-driven profitability. Given a degree of success, the CPO may indeed become the CFO's best friend. ■

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