Shivamber
SYNERGY SEEKER

Improving Procurement

HOW TO BUY YOUR WAY TO BETTER PROFITS

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ABSTRACT & SUMMATION: CEOs are becoming increasingly aware of the value a great procurement function can bring to their business. And report after report of massive cost reductions or improvements in quality and service, as well as faster time to market indicates that such interest is well warranted. Great procurement organizations work collaboratively with other functions and with their suppliers to drive broad improvements in total costs. However, in order to be most effective these organizations are ensuring they have the best talent arrayed against each strategic segment of procurement expenditures, even if they have to outsource some portion of their function. The leading organizations also recognize that information is more important than organizational structure, thus their technology investments are focused and frequently deliver value upon implementation, unlike many other misguided procurement automation efforts. Finally, these groups recognize that they are unable to build a competitive business without competitive suppliers, and make every effort to ensure relationships are such that the total system wide cost are being reduced collaboratively, for in so doing, these partnerships can deliver the greatest improvements in procurement.

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An Introduction

Between 2001 and 2002 Bayer Corp. reduced costs by $125M through improved procurement, in some cases taking radically different approaches (such as using sole source contracts for strategic chemicals) from their historical strategy. Dow Chemical saved $150M from strategic sourcing in the two years after its acquisition of Union Carbide in 2001. These were the stories in the early 2000s that served to propel the procurement function into the spotlight of corporate performance improvement levers. Since then, there have been numerous other stories from senior executives in every industry, around the world, that suggests Procurement continues to be a very fruitful source for cost reduction, both short-term and longer-term. In fact, PURCHASING magazine recently published results from its poll of Fortune 1000 purchasing executives, in which 72% of the respondents identified direct material cost reductions as one of their top three goals. Yet against a backdrop of tough economic conditions, weakened suppliers and low interest rates, many more companies are failing to grasp these opportunities to significantly reduce their costs and long-term supply risk. Why is procurement still so under-leveraged, and what should be done about it?

Procurement continues to be a very fruitful source for cost reduction

Some background

Surprisingly few senior executives really understand the scope of procurement. The approach taken is that "It's a necessary function that just needs to be measured and incented appropriately and the right things will get done". Or when the value is recognized, executives find themselves frustrated that they are unable to achieve better results that they intuitively believe are available. Sadly, procurement functions in many companies are poorly focused and as a result terribly under-appreciated. Procurement professionals are required to spend far too much of their valuable time on trivial aspects of running the business, and as a result are delivering far less than their potential would suggest. In our experience, the real value of procurement efforts can only be achieved when viewed with a strategic lens and within an integrative framework. Only when the procurement role is viewed as a strategic asset to be utilized more effectively will the promises of strategic sourcing be truly deliverable. The reality is that far more benefits can be achieved by looking more cross-functionally across the business than by merely sending the procurement function off to cut purchase costs.

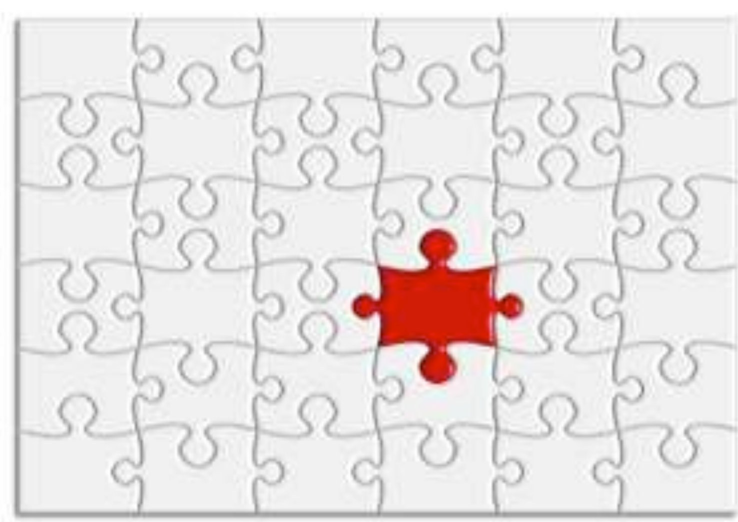
Before you can get the most out of procurement, we must remind ourselves of how procurement helps or hurts the underlying business. Then, and only then, will we have a real appreciation for the magnitude of available opportunities, and can begin to put in place actions to capture these lucrative benefits.

HOW DOES PROCUREMENT AFFECT THE BUSINESS?

Let's face it; we all agree that procurement affects costs, whether it's buying materials, finished products, or services such as advertising or temporary employees. What is not universally accepted or understood, is how procurement affects a host of other important dimensions of the business that are not readily apparent when looking at the price paid for an item:

Procurement affects a host of other dimensions not apparent when looking at price paid

- Procurement affects capital costs and obsolescence. Buy too much to get a lower up-front unit cost, and suffer the consequences of higher financing, warehousing and support costs. And if the extra items are not used, barring a sale to another buyer, suffer the write-off of material costs.
- Procurement affects the quality of your products or services. No company can create high quality products from shoddy materials.



- Procurement affects the responsiveness or flexibility of your business. When materials don't show up on time, because of poor supplier selection or inadequate supplier management, customer demand can be affected, whole factories can come to a grinding halt, and revenue targets can be missed.
- Procurement can create competitive advantages. Choose the right suppliers and you can have earlier access to new technology, processes and products. Great procurement functions find ways to collaborate with suppliers such that products get to market more rapidly, at lower total cost and at better quality.

Yes, a well managed, properly focused and appropriately measured and incented procurement function can drive enormous benefits to the business.

Common Missteps

Even those organizations that are well managed and attuned to the importance of procurement are finding significant opportunities to improve. Why is this? Many procurement organizations fail to achieve their potential by making one or more of five common missteps:

Organizations fail to achieve their potential by making one or more of five common missteps

1. Focus on purchase price rather than total costs.
2. Reliance on simplistic Pareto rather than operational segmentation, and focus on reducing purchasing costs by automating procurement.
3. Emphasize negotiations and supplier leverage rather than broader cross-functional opportunities.
4. Emphasize structural changes (centralize versus decentralize) rather than develop process capability.
5. Under-invest in procurement organization, and then involve purchasing in everything.

Misstep 1: Focus on Purchase Price

The concept of an economic order quantity (EOQ), which balances the costs of transactions and inventory, has been around a long time. And many purchasing organizations are aware of its utility, and buyers have been trained in its application. Unfortunately, today it is infrequently applied. And when it is, the simplifying assumptions applied only serve to minimize its potential benefits. With the introduction of the EOQ came the universal recognition that purchase price was only one of many variables and real costs that should be factored into every purchasing decision. The EOQ teaches purchasing organizations that if you purchase less frequently (larger quantities), you might experience price breaks that needed to be balanced against higher inventory costs (the larger quantities would last longer).

As a consequence, procurement functions innovated and devised the annual purchase contract that creates a base price for the quantity purchased over the year. At one level, they had minimized one of the significant tradeoffs built into EOQ's and thus they could ignore its application.

The next step was to drive towards lower inventory (low purchase price and lower inventory at the same time), by having products shipped in more frequently. In this process, the other transactional costs were lost or ignored. One distributor wanting to reduce its inventory, given that prices did not fluctuate with purchased quantity, decide to shift from monthly deliveries to weekly. Its warehouse costs skyrocketed, far outstripping the savings from inventory.

All purchases cost far more than the price paid on the invoice

Today, its common place for customers to require suppliers to replenish product far more frequently that the transactional-cost-increase to inventory-cost-reduction tradeoff would suggest. The reality is that all purchases cost far more than the price paid on the invoice. For example, each time something is purchased, someone in the organization may be required to: request a purchase, find a supplier, place an order, receive the order, deliver the item to the requestor, and receive, record, and pay an invoice. And all that assumes that you receive what was originally requested, and that it does not need to be inspected, and there are no service issues. In many organizations, these costs are not trivial, yet they are ignored in the procurement equation.

Misstep 2: Simplistic Pareto and misguided automation

"Technological progress has merely provided us with more efficient means for going backwards."
Aldous Huxley

General Electric managers developed the ABC classification methodology (the most common Pareto) during the 1950s to help focus its efforts on the small percentage of items that account for a large percentage of its sales. This methodology was then translated and applied to inventory management and procurement rapidly, as its utility was clear. By focusing on the small number of items that accounted for the largest proportion of its purchases, the procurement function could ensure the largest benefits were achieved. Professional purchasing organizations were built and focused on those A and B items that were "strategic" and C items were left to the users. Plant maintenance bought their own supplies, administrators bought office supplies, and a whole array of "non-strategic" purchases was left out of the domain of the procurement function. Consequently, today large portions of purchases are still being made with less rigor and control outside of the procurement function.

Let's face it, most procurement organizations spend a lot of time managing and ensuring that their A and B items are priced right. But what about those C items, or even the non-production purchases, that frequently bypass the procurement function? At one industrial company, a quick review of C items indicated prices 50 to 75% higher than market. A 25% reduction of prices on the C items (30% of total purchases) would lead to more savings than the price reductions targeted in the remainder of the procurement pool (the other 70%).

In some cases, companies have recognized this opportunity and strived to bring control to the process. At a minimum, the procurement function would have some oversight responsibility. But the transactions became overwhelming due to the large variety of items being procured. The simple answer for many has been process automation, and more recently eProcurement (an even more advanced form of process automation). Processes for requisition, approvals, orders, and payment were shifted online, reducing the organizational costs associated with transactional purchasing.

Large purchases are still made with less rigor and control outside the procurement function

Unfortunately, many of these efforts have failed to deliver on their promises and are ill conceived to begin with. Forrester Research in a recent report noted that many implementers have merely automated existing processes for approving requisitions, and in so doing have failed to achieve the real benefits. Naturally, the real benefits of a highly automated procurement cycle don't come by simply installing an application, but through real process redesign. Gartner Group estimates it will take three years to bring 50 % of the white-collar MRO procurement spending under the control of eProcurement applications, and another three years to reach 80 % of spend. That is not to say that automation or eProcurement are not useful. However, these are solutions that ought to be placed within a strategic framework and applied to those items where all costs can be reduced. Further, to maximize the value of these solutions, it is necessary to reshape processes that can minimize transactions and transaction costs without driving up prices.

Misstep 3: Focus on leveraging suppliers

A recent poll of purchasing managers identified pursuing volume leverage across business units or locations as the second-most popular current cost reduction strategy, right behind work activity and staff reductions. In 1979, Xerox coined the phrase “competitive benchmarking” when it set about to find out why its Japanese competitors were able to sell copiers below Xerox’s manufacturing cost. This process unearthed that Xerox was rejecting 10 times as many products as its competitors and taking twice as long to bring products to market. Thus was born the “Leadership through quality” program. At the heart of this program was the realization that with 9 times as many suppliers as the Japanese, Xerox would be unable to drive significant improvements without significant improvement. Soon benchmarking, total quality and supplier reduction became the mantra of any effective management program. One of the extraordinary side effects of the supplier reduction program was a significant reduction in cost as each supplier became that more important to the company, and the company to that supplier. Through co-dependency significant benefits were created for both parties.

Two decades later the cause and effect has been forgotten. Today, procurement organizations believe it is their right to receive lower prices if they buy more from a supplier, even if the costs don’t change. Let’s face it; generations of managers have been taught that the way to get lower prices from suppliers is to be a big customer whereby you can dictate terms. Whole new forms of collaborative buying organizations have been created to drive just such a benefit. And some distribution industries have become more consolidated precisely so that the consolidators could become bigger and exercise more clout over their suppliers.

Between 1992 and 1993 José Ignacio Lopez de Arriortua headed GM's purchasing in North America and is credited with saving GM approximately $4 billion in expenses. Sadly, he is also credited with causing immense harm to GMs long-term supplier relationships and its competitiveness, an impact (believed to be greater than the savings) that has taken nearly a decade to undo. López focused his teams on price, requiring that each major item be bid at least ten times. He would frequently tear up existing contracts and instruct suppliers to resubmit their winning contract bid with double-digit percentage reductions in price. And he noted to these suppliers that GM represented a major portion of the firm’s sales, and the firm would be long bankrupt by the time the supplier’s grievance found its way to a court hearing.

Focusing on price ensures that the limited interaction between buyer and supplier is adversarial

Across town, Chrysler management chose a different approach. They focused on long-term partnerships rather than short-term price concessions. Chrysler introduced systems oriented procurement selecting suppliers on their ability to contribute to the entire product development and manufacturing value chain. The results? Chrysler's product development cycle time shrunk and they were able to launch a succession of hit cars, while GM's efforts stalled in comparison. To make matters worse, Lopez left GM and took all his prices to Volkswagen, leaving the horrible supplier relationships behind. GM's price reductions were short lived.

Think that the Lopez story is an isolated case? Today, the latest tool in the buyers arsenal aimed at suppliers is a "reverse auction", a process pitting suppliers against each other in a bid to keep their previously earned business with the customer, just as Lopez did to his suppliers with at least ten bids. The difference? Web enablement makes it less personal and much faster. General Electric, seeking to achieve some of the 10 to 30% cost reductions promised by reverse auctions in its electronics components found its best suppliers opting out of any involvement in the reverse auction they required. These suppliers would decimate their existing margins (10 to 20%) for GE to achieve anything close to the benefits it expected. And what about the services and tight integration being provided to GE's factories? Was that not worth something? GE was forced to back off its requirement that electronics components suppliers be selected using a reverse auction.

Focusing on price ensures that the limited interaction between buyer and supplier will be adversarial, forget trying to figure out how to save costs or cooperate. Procurement strategists know that a focus on price or volume leverage is only a short run strategy leading to a vicious cycle of low price, followed by lower cooperation, reduced quality, reduced service and lower flexibility. Though a focus on price or volume leverage can produce short-term cost savings, experience says there are frequently far more fruitful approaches leading to deeper and more sustainable procurement cost savings.

Misstep 4: Change structure

The Center for Advanced Purchasing Studies (CAPS) conducted two studies of purchasing organizations in 1988 and 1995. A stunning 119 (41%) companies responding to both studies had changed their procurement organization structure in that seven-year period. The number shifting towards decentralization was only slightly larger than those shifting towards centralization. In a follow up study of 15 specific change situations, researchers found that the changes were typically made to confirm to a major corporate change, but in all cases motivated by an attempt to cut costs. So in every case, whether centralized or decentralized, when a company decides to change its corporate structure, it changed its procurement structure and found significant cost savings. Why then is it that Gene Richter, former Chief Procurement Officer of IBM in an article for Purchasing Magazine is so confident that *"Most procurement experts believe 15-20% of purchased materials and services can be saved (billions of dollars in a large company) by centralizing procurement and leveraging a far-flung corporation's buying power."*

Change structure merely to align with corporate structure and risk underachieving your potential

All too often, frustrated managers along with their consultants, recognizing the benefits of focusing on procurement and attempting to drive savings will choose organizational structure changes as the primary solution, only to unwind those changes years later. That is not to say that structure is not a valuable change lever, but getting procurement right is far more complicated than changing to a centralized or decentralized organization. Ask yourself, how effective would a centralized organization be if engineering decisions were being made locally? After all, the vast majority of procurement costs for production items are determined when the engineering decision to include or exclude a component or supplier is made. Or, how effective is the local or factory level group when global competitors are making the products being sourced?

Any company that decides to change its procurement structure merely to align with corporate structure changes fails to recognize the importance of other critical needs such as procurement strategy, systems, skills and shared values (or goals), and will underachieve its potential.

Misstep 5: Under-invest in organization

Procurement costs money. So much money to some companies that they are willing to invest heavily in systems to reduce the non-value-added work associated with procurement, reducing staffing at the same time of course. And of course, there are significant portions of every procurement organization that are being under-utilized or used in non-value-added activities. The reality is that many companies squander the time of their procurement resources, a very valuable asset. A focus on systems and automation understates the importance of skills, focuses on the transactional aspects of procurement rather than the strategic, and under-leverages the relationships built between suppliers and the procurement organization.

Where is the procurement organization in the pecking order? How much is being spent on acquiring new skills either through world-class talent or training? The average procurement professional is a married male in his mid-40's who has worked in purchasing for 15 years. And over those 15 years, training has been sparse. Less than one quarter of these professionals are certified purchasing managers (CPM). The fact is that many companies will hire inexpensive and lower skilled procurement staffs preferring to have them learn on the job, and then expecting them to be world savvy. And despite all the money being spent on automation, routine paperwork still occupies a third of the procurement professional's time. Procurement, to be effective, must be good at strategic and executional issues, yet firms hire with the perspective that most procurement challenges are executional. Face it; the skills, style, goals and activities associated with strategic procurement are far different from those of executional procurement. To hire into one and promote into the other is applying blind faith that executional experience teaches strategic thinking, analysis and negotiation skills.

Too many companies entrust valuable procurement to "years of experience" with little training

One large procurement organization with nearly $10B in purchases each year found fewer than ten percent of its procurement group knew how to calculate inventory turns, margins, and mark-ups, much less an economic order quantity (EOQ). The reality is that far too many companies entrust their valuable procurement to "years of experience" with "little training". If the supply market was not so dynamic, one could understand this strategy, but with procurement being such a vital element of a company's competitiveness, you would be stunned by how much better a company can perform when it invests in high quality talent.

What To Do

Against each of the missteps described earlier, is a vast array of opportunities to reduce procurement costs, both transactional and item specific. And despite well-intentioned efforts by companies to manage their procurement strategically and to drive automation at reducing transaction al costs, still we find significant opportunities for procurement organizations to deliver more to the bottom line. So what should a company do to ensure that procurement is in fact delivering value and the promises of investments to reduce costs are valued? Companies that are delivering the greatest value out of their procurement functions each adopt five practices:

1. Implement a TCO measure that captures all procurement effects.
2. Segment and refocus the organization tailoring approaches to the different requirements, including leveraging transaction-less procurement.
3. Drive strategic sourcing with executive involvement, and focus the procurement function on product and process simplification.
4. Focus on information rather than structure.
5. Attract, develop and retain world-class buyers and professionalize all sourcing functions.

Companies delivering the greatest value out of procurement each adopt five practices

Implement Total Cost Analysis

The ultimate goal of any strategic sourcing initiative should be to determine the mix of products, suppliers, and services that can support internal requirements at the lowest total cost. Total cost is the sum of invoice price and other off-invoice factors, including quality, delivery, warranty, financing, and other elements that impact what a product will actually cost an organization. For example, a procurement organization might contract for products from an overseas supplier at a significant discount to the current purchase price from domestic suppliers. However, not factored into the equation would be incremental costs incurred for transportation, import clearance and extra inventory required in case of supply disruptions. These additional factors, though not readily apparent, create real incremental costs, which may offset the appealing price savings.

TCO thinking forces organizations to think more broadly than just the price paid

Few companies do a good enough job of tracking their finished product costs appropriately. Current cost systems are designed to spread costs evenly across a broad cross-section of products regardless of cause and effects. Proponents of Activity Based

Costing (ABC) have demonstrated the folly of such a naive methodology. The same could be said for procurement costs, which are likely to receive far less attention than product costs. The problem for procurement though is that unless these costs are tracked and attributed back to the root supplier or material, little improvement could really be experienced in costs. Procurement organizations would literally be driving their improvement programs blindly. Take for example the wool felt manufacturer that discovered by paying a 20 percent premium for higher grade wool, fewer needles would be broken in the process, machine uptime would increase, and quality product output would increase by far more than the price increase. Or the window manufacturer that discovered higher-grade lumber would produce more useful long pieces, requiring less splicing and would produce more useful window frames than the price premium.

IT buyers have been hearing the term “Total Cost of Ownership” (TCO) used in product pitches for some time now. Simply put, TCO is the present value of all costs associated with product, service or capital equipment that are incurred over its expected life. And it is used primarily in helping make decisions when the purchase price is only one of many other costs that can significantly change the decision. The value of TCO thinking is that it begins to force organizations to think more broadly about the choices of suppliers, materials, or technologies than just the price paid.

Take for example the electronics designer who has been trained in the use of application specific integrated circuits (ASIC), which have to be custom designed and made. These ASICs have a large design and testing cycle, and require significant up-front non-recurring engineering charges. But in some cases a programmable device made by companies like Altera or Xilinx can replace an ASIC. These devices require a far shorter design and test cycle, and the functionality can be changed up to the moment the product is manufactured. While the programmable device has no minimum volume requirements, they do have higher variable purchase prices. So if time to market and flexibility is valuable or, for a large range of low-volume products, the programmable device may be preferred to the ASIC design, despite the higher per unit cost. And if the procurement and design organizations are not measuring all of the costs and weighing these trade-offs appropriately, the business is probably missing a large opportunity.

Understanding the detailed cost elements of a chosen component or supplier helps procurement organizations make more informed decisions about which item or supplier is a better fit strategically.

Segment and Tailor Approaches

"There is nothing so inefficient as making more efficient that which should not be done at all."
Peter Drucker

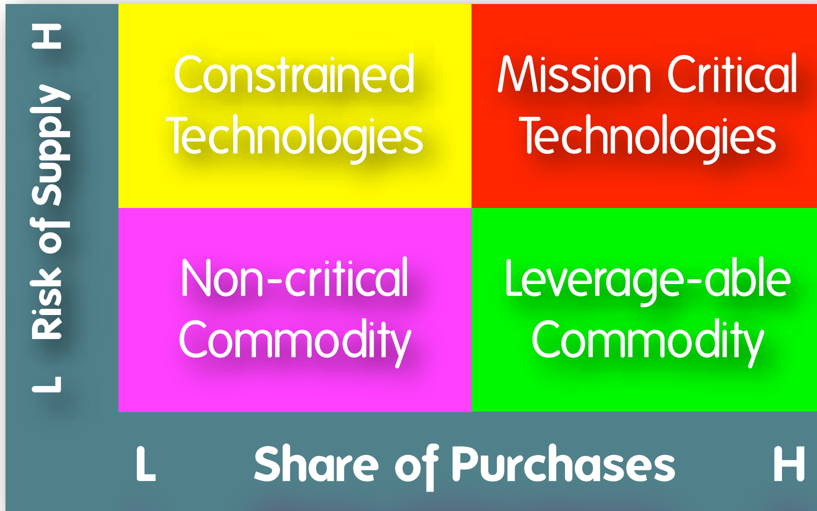
Segmentation, though used primarily in marketing organizations for customer grouping, is incredibly important from a procurement perspective because of its value on focusing an organization on the different types of decisions or issues that need to be addressed. Take the ABC Pareto example described earlier. Suppliers that sell a lot of stuff to a company or items that represent a large value of the total procurement expenditure require a different level of activity than those at the other end of the spectrum. Where the ABC is misused is in the assumption that lower valued items do not require as much focus as the others. For as we described earlier, the low value items frequently incur significant transactional costs and because they are not managed professionally or strategically incur severe price penalties. The reality is every segment of suppliers or items no matter how trivial require both strategic and transactional efforts. The level of such effort and the impact on opportunities will depend on the specific business and degree of review previously expended on those segments. If for example, you have never reviewed the lowest 30% (C items) strategically, then you may be missing opportunities to reduce total costs in these products by as much as 50%.

One of the challenges with good segmentation is knowing what to include. Amazingly, few companies think of procurement beyond the most obvious production or service items that have the highest visibility. The reality is that a vast level of expenditure is under- or un-managed. What about copiers, travel, office supplies, temporary help, house keeping or security? Do these come under the purview of procurement, or are they part of an organization with even less training in procurement methodologies? Employee benefits are one of the largest expenses yet are managed wholly within the Human Resources function without real procurement assistance or focus. While these areas may have complications that require them to be managed under other functions, non-traditional procurement represents far too much in

Each segment requires tailored approaches, skills and systems

expenditures to be given short shrift. These, like other expenditures demand some level of rigor and a tailored approach to the inherent strategic and transactional issues.

Probably the most effective segmentation we use is one that arrays procurement expenditures in categories or items and by suppliers within a four-box grid as shown. The two axes we use are the original ABC Pareto analysis arraying procurement by the value spent, and an assessment of the risk to the business of supply. Expenditures can then be broadly group into four groups or segments requiring similar challenges and procurement focus.



SEGMENT	CHARACTERISTICS	ISSUES	OPPORTUNITIES
Non-critical	✳ Low value ✳ Transactions vary from low to high ✳ Supply is readily available with multiple suppliers ✳ Typically includes items like Office supplies, MRO and other incidental purchases	✳ The large volume of transactions and the general unpredictability of demand makes this a difficult segment to manage ✳ Procurement functions typically take simplistic approaches to this segment abdicating responsibility to others and resulting in premiums which could be very large in the overall scheme	✳ Put in place transaction-less replenishment approaches when possible ✳ Look for a narrow selection of suppliers such as distributors who can provide a variety of products and services at the lowest total cost ✳ Consider e-Procurement solutions where transaction-less approaches cannot be put in place
Leverageable	✳ High Value ✳ Supply is readily available with multiple suppliers ✳ Significant number of substitutes available ✳ For a large company this segment will include items such as personal computers	✳ The value spent in this segment makes it critical for managing well. However, because the risks are low, the management issue is primarily that of getting the best total cost	✳ Put in place transaction-less replenishment approaches when possible ✳ Narrow supplier selection might increase opportunities for cost reduction ✳ Consider auctions and vertical exchanges

SEGMENT	CHARACTERISTICS	ISSUES	OPPORTUNITIES
Constrained	✳ Low value ✳ Supply is not broadly available ✳ Markets might be monopolistic with high barriers to entry ✳ Substitution may be difficult	✳ The small value involved belies the importance of this segment which because of the risk needs to be monitored and managed carefully ✳ Because of the supply challenges, the procurement priority is to ensure supply is available at a reasonable cost	✳ Vertical exchanges or other aggregation mechanisms allow more even balance between supplier strengths and buyer needs ✳ Focus should be on developing alternatives (preferably of a leverageable product or supplier)
Mission Critical	✳ High Value ✳ Supply is not broadly available ✳ Markets might be monopolistic or oligopolistic with high barriers to entry ✳ Substitution may be difficult or time consuming ✳ Includes items that are strategically important	✳ The value and criticality from a supply stand-point make this a very important segment to manage well both to affect total cost as well as risk ✳ Relationships and cross-functional collaboration are important in getting this right	✳ Put in place transaction-less replenishment approaches when possible ✳ Drive towards better supplier integration ✳ Seek out alternatives to reduce risk ✳ Consider make versus buy, alliances, long-term contracts, etc. ✳ Consider private exchanges or portals

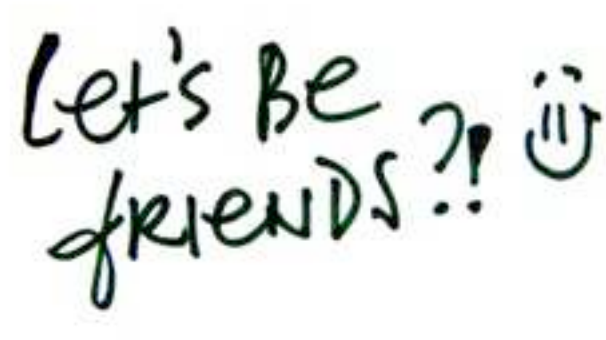
What should be obvious on perusal of a procurement segmentation framework is that a variety of issues are evident requiring tailored approaches, skills, and systems.

While the layers of strategic effort and the opportunities for reducing total cost or supply risk are different, every segment shares one common requirement – that every item must be procured and therefore requires a similar set of activities or transactions. These activities may range from searching for a supplier, managing several bids, placing an order all the way to receiving the product and eventually paying the supplier upon receipt of an invoice.

For some companies a procurement transaction may cost as mush as $100. And frequently, particularly for non-critical items, the total value of items being purchased in a transaction might be less than the transaction cost itself. Which is why so many organizations, recognizing that large number of transactions cost real money, will drive towards automated solutions precisely to reduce the cost of each transaction. And, in many cases, the systems solutions will reduce those transactional costs. What this solution fails to recognize though is that every transaction requires two parties, the buyer and the seller, on two separate systems, performing a similar set of activities.

The reality is that many companies can achieve far greater savings by implementing transactionless approaches whereby one of the parties is responsible for a single transaction that is valid for both parties. Electronics distributors such as Arrow or Avnet do just this for customers when they implement stores within the factory and replenish production lines. They track the usage of materials and replenish based on the customers' production schedules. The transaction costs for one party are entirely eliminated. This approach unfortunately is severely underutilized and remains a significant opportunity for total cost reduction.

DRIVE SUPPLIER RELATIONSHIPS



We have said earlier that too many companies focus on leverage and miss greater opportunities to reduce cost. That is not to say that supplier negotiation skills are not necessary. Far from it, leading procurement firms negotiate with their suppliers as aggressively as their customers do with them. To do less would be to relinquish your business to a long-term margin squeeze with customer prices shrinking faster than costs. No, negotiations are necessary, but they must be coupled with a more collaborative approach with the supplier, not the traditional adversarial approach. Both the organization and its suppliers are beneficiaries of the sale of a product or service in which their value or component is utilized. Driving down total costs and increasing total market penetration is advantageous to both parties. For both, the complete supply chain is one seamless whole regardless of corporate boundaries and opportunities to reduce total costs are eagerly embraced. Back in 1986 Honda selected Donnelly Corp to build all the mirrors for the cars built in North America. Until then, Donnelly made the interior mirrors, and another supplier provided the exterior mirrors. Donnelly did not even have a factory to build exterior mirrors. Yet Honda had confidence in the alignment of the companies' goals, culture and values such that they agreed on this partnership and Donnelly built a new plant to make exterior mirrors. A decade later, Donnelly sales to Honda had increased more than twelve-fold.

Product and process design are the primary determinants of cost. Choose to deliver a service in a certain way, or manufacture a product with a certain specification and component, and the cost is cemented with small layers of variability. However, engage and integrate good suppliers in the design and you can reduce total costs significantly and significantly accelerate the time to market. Michigan State University's Global Procurement and Supply Chain Benchmarking Initiative found that cross-functional teams involving suppliers drive revenue and profit growth from access to new technologies and process innovations much faster than not. The reason why integration early in the design process leads to such massive benefits is that product and processes are simplified for both supplier and customer simultaneously. Transactional redundancy can be eliminated, designs can be reused, and components can be rationalized, best practices shared and concurrent engineering can be brought to bear on the problem.

Great supplier relationships don't just require supplier integration in product and process design, there is far more to it than that. For one, they are stunningly fact based. This means that procurement teams that want to work effectively with their suppliers have to be astute at Market/Industry Analysis, Target Costing, Cost Sharing/Cost Breakdown, Competitive Assessments/Teardowns, Value Analysis, Activity Based Costing, and Total Cost of Ownership among other skills. And these relationships are not merely between procurement organizations and suppliers selling organizations. They are across the board, from top to bottom. Strange as it may seem, companies feel slighted when their senior executives are unable to gain access to the most senior customer executives, yet they commit the same behavior in their treatment of their own suppliers. Great supplier relationships require senior executives to become personally involved in the process of cementing a true partnership.

Focus on Information

The perfect supplier provides great service, has very short lead times, always delivers the correct quantity on time, never has a quality problem and does all of this at reasonable prices. The value of a supplier should at the very least factor in performance on each of these six goals, in addition to other strategic dimensions such as capacity or technology investment. But if your company is not measuring these variables or not explicitly making them a part of the total cost equation, then how do you expect to see improvements other than price?

Primarily because of a lack of information, many companies are compelled to drive towards centralization only to find themselves experiencing service and other problems. Should the solution for better procurement be collaboration and coordination or a structural change towards centralization? Some companies find it easier and faster to make a structural change, but whichever the solution put in place, the fundamental requirement for information does not change. As described before, procurement is a team activity, requiring broad cross-functional involvement and collaboration to be most effective.

Today, procurement functions must depend on a mix of online and offline information sources. Sadly, the lack of integration or basic data collection and analysis seriously inhibits knowledge transfer and collaboration within and across enterprises. Without such fluid information flows and knowledge sharing, a procurement organization is unable to understand its spending patterns and purchase requirements and wont be able to develop the most effective sourcing strategies. Why then are companies struggling to build the requisite data warehouses across their multiple factories and divisions? Unfortunately, while this lack of data integration continues, the results are that procurement teams are forced to start each project from the beginning rather than building on existing learning.

The bullwhip effect has been documented and discussed quite extensively. The effect is demonstrated when small consumer variability is misinterpreted by each participant in a supply chain resulting in significant variability at the end of the chain. The lessons learned upon observation bring to clear focus the impact of poor information quality, in this case distorted by participants in the supply chain, resulting in extra costs due to missed production, inventory pile-ups or lost customers due to stock-outs or improper service.

The foundation for a big decentralized company acting as one is a credible base of information

The challenge of making big, decentralized conglomerates behave more like single companies when it comes to procurement requires a great deal of collaboration and coordination, and as a foundation a credible base of information.

Hire the best (outsource if necessary)

"The ability to learn faster than your competitors may be the only sustainable competitive advantage."
Peter Senge

Though systems and information are vital elements of a good procurement improvement effort, they are only necessary to drive more valuable utilization of critical procurement skills. The basic operational mantra of procurement organizations should be to drive non-value added activities out such that the skills of the team could focus on the most fruitful elements of value creation. From the preceding discussion, it should be clear that procurement organizations, in order to be most effective, require a variety of skills. What is clear is that firms that are delivering the largest short- and long-term benefits are focused on skill building, procurement organizational productivity and strategic focus. These great companies:

- Hire the best and pay correspndingly
- Diversify their skill base having diverse talent and backgrounds in place
- Provide a management career path
- Promote general management skills rather than years of experience
- Provide significant opportunities for internal and external training
- Create and utilize quantifiable metrics and set tight goals, and

- Promote moves across business units to promote best practice sharing and knowledge transfer

The skills required to build a world-class procurement organization are quite broad and comprehensive. And, it is unlikely that every firm could afford to reach the level of appropriate talent with its own staff. In those cases, it may be in the best interest of some firms to find an outsource solution whereby talent can be shared with other companies, as in constrained procurement described above.

Procurement automation and standardization, and building high quality procurement data warehouses are all actions that make procurement outsourcing (partially or wholly) a reality. There are two basic rationale for business process outsourcing: first, an organization cannot perform the process competitively, or second, the process does not contribute to an organization 's competitive differentiation and could be outsourced to reduce costs or free up resources. Portions of the procurement function could be outsourced, in some companies, and justified under both of these conditions. Strategic procurement can provide an organization a competitive differentiation if performed to excellence. Commodity procurement excellence can save organizations money, but rarely can it provide competitive differentiation, at least for any length of time. Rather, commodity procurement can provide a negative differentiation when it's performed poorly. It is a process that only gains visibility when there is a problem. Services procurement and management has both strategic and commodity dimensions. So as the question of building the appropriate procurement skills shifts towards outsourcing as a choice, it is becoming increasingly obvious that for some portions of the procurement portfolio of activities, outsourcing is a viable alternative.

Conclusion

Procurement driven performance improvement opportunities are real, they are large and they are capturable. Great procurement functions understand cost, not just price. They are not monolithic, they use a variety of approaches for managing suppliers driven by well thought out segmentation. They understand the value of a supplier and strive to leverage these cherished relationships. They are data-based, analytical and value information. Finally, they recognize the value of creativity and the requisite talent to enable a rich flow of great ideas.

Let's face it; one way or the other, procurement has the potential to shape the performance of your company. Done poorly, your procurement function could force you to exit otherwise attractive businesses, leave a lot of money on the table, or worse. When performed well, the procurement function adds enormous value to the strategic equation, helping to reshape the economics of your business and the fundamental basis by which your business can compete.

Summary

CEOs are becoming increasingly aware of the value a great procurement function can bring to their business. And report after report of massive cost reductions or improvements in quality and service, as well as faster time to market indicates that such interest is well warranted. Great procurement organizations work collaboratively with other functions and with their suppliers to drive broad improvements in total costs. However, in order to be most effective these organizations are ensuring they have the best talent arrayed against each strategic segment of procurement expenditures, even if they have to outsource some portion of their function. The leading organizations also recognize that information is more important than organizational structure, thus their technology investments are focused and frequently deliver value upon implementation, unlike many other misguided procurement automation efforts. Finally, these groups recognize that they are unable to build a competitive business without competitive suppliers, and make every effort to ensure relationships are such that the total system wide cost are being reduced collaboratively, for in so doing, these partnerships can deliver the greatest improvements in procurement.

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Mr. Shivamber grew up in South America, and has lived and worked on five continents. He is keenly interested in driving international collabortion, American competitveness and is a frequent speaker on the Supply Chain, "state of the art" technology applications and issues such as Cybersecurity, Geospatial Intelligence and Big Data. He earned a bachelor's degree in business administration from Baruch College of the City University of New York, and a master's in business administration from Indiana University. He has been named a Distinguished Immigrant CUNY Alumni, is currently a Director of the Baruch College Fund, and a member of the Executive Advisory Board of the College of Business Administration of Abu Dhabi University.

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