


Financial Management in Procurement



Financial management in procurement should aim to maximise value for every member in the value chain while minimising costs and reducing risks (Monczka et al., 2009)



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Introduction

Financial management in procurement is a broad subject encompassing areas such as financial planning, control and decision-making in purchasing and supply management (Drury, 2007; Handfield and Nichols, 2002).

The aim of financial management in procurement is to maximise value for every member in the value chain while minimising costs and reducing risks (Braithwaite and Samakh, 1998; Monczka et al., 2009). Choosing the appropriate costing technique is an important step in achieving this goal.

'Whole life costing' (WLC) techniques bring increased awareness of total costs, providing buyers and decision-makers with increased knowledge of the factors affecting cost and the resources associated with procurement (CIPS: Whole life costing). WLC methods also offer accurate forecasting of the full cost of a purchase over a given period which can help with important for major investment decisions (CIPS: Whole life costing). Similarly, 'activity-based costing' (ABC) methods provide managers with information about how each activity contributes to overall profitability by utilising cost drivers to attach activity costs to outputs (CIMA, 2005). ABC techniques can also provide insights about future procurement decisions and investments (CPS, 2007).

P&SM; emphasises maximising value for customers while minimising cost for companies, making 'cost-to-serve' (CTS) techniques relevant (Braithwaite and Samakh, 1998). Tracing activity costs to customers and distribution and delivery channels allows a company to benefit from: 1) protecting existing highly profitable customers, (2) repricing expensive services based on CTS, (3) discounting business with low cost-to-serve customers, (4) negotiating win-win relationships that lower cost-to-serve for cooperative customers, (5) permanently conceding loss-making customers to rival companies and (6) attempting to attract high-profit customers away from competitors (Kaplan and Cooper, 1998).

Definition

Financial management in procurement involves the "management of all the processes associated with the efficient acquisition and deployment of both short- and long-term financial resources", as they relate to the procurement of goods and services (CIMA, 2005:90).

Successful Application

There are many different techniques implicated in financial management on procurement. For illustrative purposes the implementation information applies to spend analysis. Overall, there are five sets of questions a company needs to work with when using spend analysis:

1. What was the organisation-wide spend associated with each cost centre in the previous year? Will the aggregate spend amount enable the company to increase leverage with suppliers?
2. What are the top commodities? What does the spend trend look like over the past few years? Which commodities present opportunities for spend reduction?
3. Which suppliers are the most valuable and strategic?

4. How much is the organisation spending with preferred suppliers and how much is being spent with under-performing suppliers? 5. What percentage of spend is associated with contracts (Pandit and Marmanis, 2008).

Steps to Successful Application

- Ascertain true category spend.
- Identify strategic sourcing opportunities through demand aggregation and supplier rationalisation.
- Identify means of reducing expense through increased compliance by looking at vendor rebates, maverick spend, contract compliance and budget variance.

Pandit and Marmanis (2008)

Hints and Tips

- Collecting and extracting spend data on its own does not automatically generate useful 'intelligence' (Bartolini and Dwyer, 2008; Supply Management, 2008).
- The information entered into the spend analysis needs to be high quality: a survey found that 55% of companies cite poor quality information as a major obstacle (Supply Management, 2008).
- Innovative companies classify their spend by vulnerability (e.g. risk or exposure to market failure in procuring a good or service, strategic importance of purchased goods or services), and value (e.g. effect of a purchased good or service on overall costs or profits) (RAND, 2004).

Potential Advantages

- Good financial management can help minimise cash outflows. For example, it helps to avoid unfunded changes to a project (including purchase order amendments) and perform all critical tasks on time (CIPS: Whole life costing).
- Good financial management can help maximise cash inflows by performing all critical tasks on time, as late-running tasks delay the times when interim or final invoices can be issued to customers (CIPS: Whole life costing).
- Spend analysis as a financial management technique can significantly enhance performance and generate savings (RAND, 2004). The savings from a spend analysis usually fall within 2-25% of total spend (Pandit and Marmanis, 2008).

Potential Weaknesses

- Financial management in procurement is inevitably resource intensive, as spend analysis requires analysing considerably large volumes of data (Pandit and Marmanis, 2008).

- For strategic procurement decisions, the disadvantage of the WLC technique is that future costs are only approximations and are based on projected sales figures which are frequently over-optimistic (CIPS: Whole Life Costing).
- The ABC method relies largely on the assumption of proportional activity cost structures. It can be costly to implement and maintain (Yahya-Zadeh, 1998).

Performance Monitoring

- Spend under management: a traditional measure of procurement's impact on a company is the percentage of all non-payroll related spend falling under management of this group (Bartolini and Dwyer, 2008).
- Supplier scorecard: can be used to assess the performance of key suppliers (e.g. financial spending details with each supplier, e-transactions to date, supplier performance, quality of goods, service and logistics ability, and payment terms) (Eakin, 2003).
- Compliance to negotiated contractual agreements (Bartolini and Dwyer, 2008).
- Net Present Value (NPV): the net present cost of the purchase or project and all future revenues flowing from it discounted back to the present time (CIPS: Whole life costing).

Case Studies

- Previously criticised for poor financial management, the UK's Ministry of Justice introduced a new procurement system with a detailed breakdown of their £3.5bln spend on goods and services. By managing HR, finance and procurement as a single system, the shared services programme aims to save £28m a year by 2014 (Supply Management, 2011).
- Boeing Commercial Airplane Group Wichita, a cost centre plant of the world's largest manufacturer of commercial airplanes, implemented ABC realising a 20% reduction in the parts needed to be reworked. One shop alone saved US\$900,000 per year in rework costs and there was also a significant reduction in overtime hours due to the reduction of the rework activities (Labor Aerospace Research Agenda, 2001).
- Ahold, a company responsible for sourcing goods for six grocery brands and over 1,200 US supermarkets, launched a strategic sourcing programme in 2003. The programme generated US\$350m worth of savings in two years on indirect procurement. The company partly relied on a web-based spend analysis application allowing corporate-wide spend visibility and giving managers the ability to 'slice and dice' spend data in real time, identify vendor consolidation opportunities and generate actionable reports on a continuous basis (Pandit and Marmanis, 2008).

Further Reading/Resources

Web Resources

- A case of poor financial management on procurement
<http://www.supplymanagement.com/news/2010/ministry-of-justice-slated-for-poor-financial-management/?locale=en>
- Rethinking ABC by Robert Kaplan and Steven Anderson
<http://hbswk.hbs.edu/item/4587.html>
- Key insights of a 2008 spend analysis survey
<http://www.supplymanagement.com/news/2008/most-spend-analysis-comes-to-naught/?locale=en>
- Procurement Guide for Managers
<http://www.cps.gov.uk/publications/finance/procuremansguide.html>

Books

- Accounting in a Business Context, Robin Jarvis & Aiden Berry, ISBN 978-1844802517
- Financial Accounting and reporting, Barry Elliott & Jamie Elliott, ISBN 978-0273760887
- Management Accounting for Decision Makers, Dr peter Atrill & Eddie McLaney, ISBN 978-0273731528
- Modeling the Supply Chain, Jeremy F. Shapiro, ISBN 978-0495126096

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Video

Financial management basic concepts

https://www.youtube.com/watch?v=FNkFAUFxQIs&feature=player_embedded

CIPS Group Easton House, Easton on the Hill, Stamford, Lincolnshire, PE9 3NZ, United Kingdom
T +44 (0)1780 756777 F +44 (0)1780 751610 E info@cips.org

CIPS Africa Ground Floor, Building B, 48 Sovereign Drive, Route 21 Corporate Park, Irene X30, Centurion, Pretoria, South Africa
T +27 (0)12 345 6177 F +27 (0)12 345 3309 E infosa@cips.org.za

CIPS Australasia Level 8, 520 Collins Street, Melbourne, Victoria 3000, Australia
T 1300 765 142/+61 (0)3 9629 6000 F 1300 765 143/+61 (0)3 9620 5488 E info@cipsa.com.au

CIPS Middle East & North Africa Office 1703, The Fairmont Hotel, Sheikh Zayed Road, PO Box 49042, Dubai, United Arab Emirates
T +971 (0)4 327 7348 F +971 (0)4 332 5541 E mena.enquiries@cips.org



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