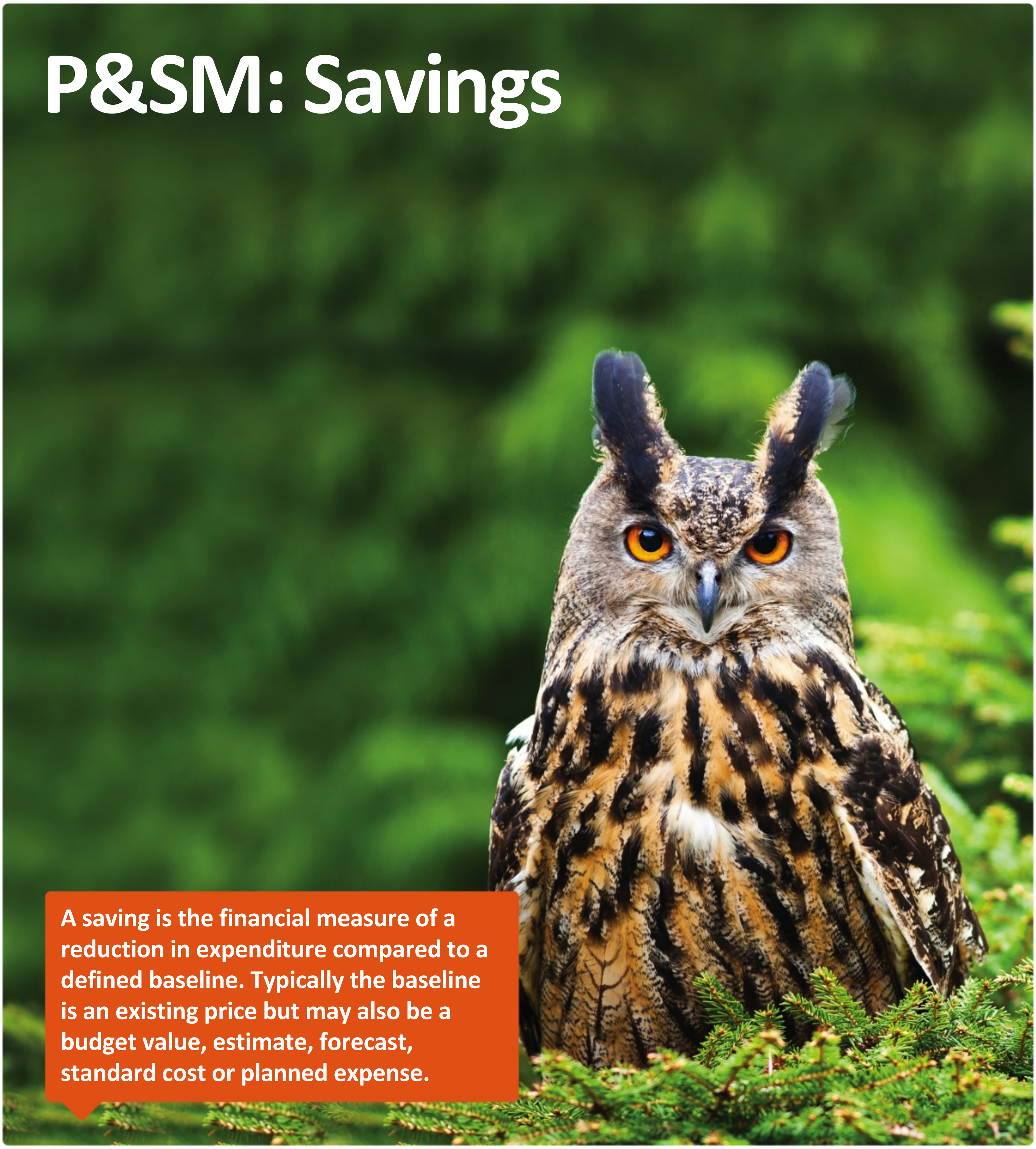
CIPS KNOWLEDGE

P&SM: Savings



A saving is the financial measure of a reduction in expenditure compared to a defined baseline. Typically the baseline is an existing price but may also be a budget value, estimate, forecast, standard cost or planned expense.

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Introduction

The CIPS' practice documents are written as a statement in time. They are a collection of views on good practice within a particular subject area and are intended to provide direction on good practice with some guidance for context and interest. The reader is encouraged to use the CIPS practice documents for their own purposes, such as writing policy statements, guidance or procedures. This particular practice statement has been written primarily for the benefit of full-time purchasing and supply management professionals, but can be used by anyone associated with, or interested in, purchasing and supply management (P&SM).

This document is about savings.

Definition

A saving is the financial measure of a reduction in expenditure compared to a defined baseline. Typically the baseline is an existing price but may also be a budget value, estimate, forecast, standard cost or planned expense. Understanding the baseline and its like-for-like comparison in financial terms is critical to the effective measurement and reporting of savings. Savings must be based on robust savings analyses and there are three potential areas where savings can often be realised. These are through improving demand, supply and total cost management through restructuring business processes and relationships.

Measurement of savings is often confounded by the results of other P&SM performance factors, such as changes to quality that are implemented at the same time as price changes (CIPS positions on practice on measuring the performance of P&SM are also available on this site). Similarly, the achievement of savings is often contested between departments, especially where multi-disciplinary teams are involved with purchasing in, for example, value-engineering initiatives to reduce cost. A true saving is only made when the following factors related to the item or the service remains unchanged: performance (including outcomes, service and quality), through-life cost and timeliness.

Cost avoidance is the financial measure of resistance to unbudgeted, unplanned or unexpected price increases that have not been considered in the baseline price. Cost avoidance is not a saving, but is important and should be included as part of the overall measurement of P&SM performance.

Background

The following are examples of bona fide categories of savings:

- agreeing a straightforward reduction in price (eg. obtaining the same item for less cost)
- sourcing, or developing with the supplier, a different quality item (a change in specification that still meets purpose) at reduced cost
- improved performance, ie. obtaining more value in relation to the defined baseline for the same cost where this can be defined in financial terms (eg. obtaining spare parts as part of the capital price of some new equipment)
- negotiating retrospective rebates and improved payment terms
- improved business processes (eg. real savings in spent and related costs as a result of re-structuring, eg. e-procurement)
- reducing commercial exposure, eg. by identifying and mitigating all forms of risk in any pro-curement

An example of a perceived saving which does not fall within these categories is when, following a tendering exercise, the cost of the tender accepted is compared to the cost of the highest tender and the difference is seen as the proposed saving. However, if the budget holder or end user would have purchased from a higher cost option, such as the supplier which offered the highest tender (ie. without competition), and the intervention of the P&SM professional resulted in a lower cost option being selected this would be a benefit worth declaring. Whether this represents a saving or cost avoidance, or a mixture of both, depends on an understanding of the baseline.

The cost-saving examples given above are simple savings, but savings can also be complex and difficult to measure and value. A typical example is when the P&SM team have negotiated lower prices for a particular requirement but the demand rises and therefore the overall expenses associated with the requirement increase. In this example the rise in demand may negate some of the initial cost savings.[1]

Explanation

CIPS recommends that P&SM professionals work closely with finance and other colleagues in key functions on costings, budget preparation, savings prediction, tracking reporting and capture. For instance, finance and procurement should agree an appropriate savings measurement for key expenditure. The publication of detailed plans for addressing the organisation's expenditure is an important tool for communicating targets and establishing the baselines for results measurement.

Savings can be measured as 'In-Year' numbers, ie. relating to the budget, or 'Full-Year' relating to the annualised impact, that is to say a 12 month equivalent. Full Year savings credit has the benefit of reducing the temptation to report savings in the first month of the financial cycle. Savings analysis should be linked where possible to the organisation's financial accounts.

CIPS also believes that forecasted potential savings that are agreed with the budget holder should, where possible and appropriate, be fully or partially removed up front from the budgets so that the organisation can utilise the saved money for alternative investment opportunities as early as possible.

The decision on the utilisation of savings should normally be one of the following three options:

- leaving the money in the departmental budgets to allow the budget holder greater freedom on other fronts; great care must be taken to ensure that the real saving is recognised
- investing the savings into other company expenditure
- increasing cash balances which, in the case of savings against revenue (as opposed to capital) expenditure, transfer to increased profits

These decisions do not come within the purview of the P&SM professional, but are rather the responsibility of finance. However, P&SM professionals should always highlight, deliver and report savings in order to enhance business awareness, visibility and transparency.

[1] http://www.capgemini.com/procurement-blog/2011/11/17/measure-procurement-savings/ last accessed 26th October 2012.

Achieved savings that are not reported could be seen as negligence as it could deprive the organisation of greater investment elsewhere. CIPS also believes that P&SM professionals must report current and potential cost increases as well as savings.

CIPS believes that it is a key responsibility of P&SM professionals to measure their own performance, and that of their teams, together with the overall value which they add to their organisation on at least an annual basis. However, CIPS recognises that each organisation has its own demands and therefore the frequency, complexity and level of reporting is not generic across all P&SM functions. One of the key components of this performance is the impact of professional P&SM on the financial performance of their organisation.

The results should be a vehicle with which to raise the profile of P&SM, and thereby promote it in the organisation. CIPS believes that all P&SM professionals should continually endeavour to promote their profession, as well as themselves, thereby raising its profile. Members should also promote the value of CIPS (CIPS positions on practice on promoting P&SM are also available on this site). However, CIPS recognises that, more often than not, P&SM professionals do not deliver savings single-handedly; rather, savings are a result of cross-functional working. Therefore, it is also important to encourage and publicise the benefits imparted by cross-functional teams.

Organisations often impose performance targets on the P&SM professional and these are usually expressed in financial terms, most commonly as a price reduction. However, price is just one component of cost. Non-P&SM professionals often perceive savings on price to be the only indicator of purchasing performance. CIPS believes that it is a key responsibility of the P&SM professional to promote the concept of total cost of ownership and through-life cost.

CIPS advocates that P&SM professionals ensure their objectives, strategies and practices are in accordance with, and therefore support, those of their organisation. This may mean that P&SM professionals procure goods and services at a higher price than previously paid by their organisations, if this delivers agreed corporate objectives such as better performance, greater profitability or improved market share.
Notwithstanding this, P&SM management professionals should always endeavour to obtain good value for money, even for the most expensive items.

Measurement

CIPS believes that all reported savings must be quantifiable, measurable and tangible. They must also be auditable and verifiable. CIPS also considers that P&SM professionals should commit themselves to continuous improvement year on year. It is important to build on the previous year's reported savings and demonstrate on-going improvements. It could be argued that some commodity prices may increase year on year; in such circumstances P&SM professionals should be monitoring (insofar as this is possible) prices paid by their competitors or others, market indices and those prices being offered by the supplier's competition. The objective should be to purchase the commodity at a given time at less than the average annualised price of the commodity.

P&SM professionals should balance the pursuit of additional savings for a given requirement by targeting, prioritising and resourcing accordingly. Targeted areas should be reviewed and appropriate action taken to reduce cost in respect of the product or service in question. This might form part of a partnering arrangement or a supplier development programme involving, for example, value analysis and value engineering as appropriate; always ask people with detailed expertise at good suppliers where they perceive savings can be made, internally and externally (CIPS positions on practice on partnering and CIPS positions on supplier development are also available on this site).

This may also involve working cross-functionally with colleagues to review the requirement, re-sourcing or re-tendering to facilitate continuous improvement. A further example would be to encourage suppliers to move their business to a location/country with a lower cost economy; however, caution should be exercised here as additional costs in terms of location and security of supply may counteract the advantages associated with the lower cost economy.

Conclusion

CIPS does not suggest that savings are the only, or indeed the most important, contribution from the P&SM profession; the skills and competencies of a qualified P&SM professional will deliver enormous value to any organisation by contributing to its future well-being. It is, however, an area where P&SM professionals can provide particular value to their organisation and this value will help to promote the profession and raise its profile.

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