CIPS Australasia

CIPS KNOWLEDGE

Why Do We Need Professional Procurement?

We need professional procurement because it delivers greater benefits than it costs and it helps business and government better manage business decisions. Its value can be demonstrated in a simple business equation, return outweighing investment.

1 CPD HOURS

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Professional buying is a new specialisation emerging in the same way that accountancy or the law has. The modern role of professional procurement is a complex one demanding a wide range of business skills and commercial expertise to succeed. The job is as broad and as deep as the practitioner makes it and their organisation requires. The simple purchase contract can all too often be expected to carry the burden of lazy or hasty business development work when neither the commercial deal, the specification, nor the business process has been properly thought through. When the contract is striving to clarify what has actually been agreed - or more precisely not agreed – within the “spirit” of an amicable agreement, a procurement professional is needed.

Procurement is the profession of external resource management in the same way that HR, IT and Property teams may be the professions of internal resource management. Working both upstream and downstream of the purchase decision, a professional buyer can facilitate the business process, help capture the business benefits of the project, protect the business from risk and reduce lifetime costs.

They can be the difference between success and failure given the support and confidence to be involved.

Buyers can contribute at a professional level (reducing cost & risk) a tactical level (capturing benefits & improving quality) and at a strategic level (creating innovation & business planning). Or if you like, they can benefit cash-flow, the P&L account and the balance sheet.

Of course, professional status and involvement has to be earned. Benefits have to be identifiable – preferably quantifiable. This is the greatest challenge facing our profession and many other professions as well. Indeed, ‘performance measurement’ was identified in our recent new research as the top issue in our field. Working to ultimately resolve this question is an example of one of the ways that CIPSA aims to help both individuals and organisations improve their purchasing performance.

Benefits of Better Procurement:

- Security of supply
- Lower cost
- Reduced risk
- Improved quality
- More added value
- Greater efficiency
- New innovations

The CIPSA mandate is at all times to act in the wider Australian public interest and the interest of the profession within Australia. Within this mandate CIPSA has a dual role. Firstly to develop individual and organisational supply side performance and, secondly, to provide a voice for the profession. Many procurement professionals are asking us for help in advocating the benefits of professional procurement and that is why we have produced this booklet. It is designed to help you argue your case. Professional procurement has too great a contribution to make to fall at the hurdle of advocacy. Most professional procurement teams deliver real benefits, they just have to prove it.

Why Purchasing is Key

Without effective strategies to co-ordinate purchasing and to manage supply lines, organisations lose their way: costs spiral out of control; customers and members of the public are let down and the reputation of the organisation is damaged. Purchasing and supply management, therefore, should not be seen as a backroom, peripheral function but as a key business process.

In today's high-pressure environment, the role of purchasing and supply management has additional importance. For organisations of all types, the challenge is to improve the quality of products and services while driving down costs. This booklet explains how good purchasing and supply management practices can help to square that circle.

Cutting costs, improving efficiency

Over the past few decades, efforts to cut costs have tended to focus on head-count. The elimination of unnecessary activities, productivity drives, automation and contracting out (or outsourcing) have all seen workforces shrink. Although right and necessary in many cases, such programmes have obvious drawbacks.

They increase short-term costs, are time consuming to administer and, if not properly managed, run the risk of creating severe staff morale problems – possibly leading to industrial action. They can also store up trouble for the future: if you let good staff go you might have a skills crisis when things pick up again.

The emphasis on personnel reduction has been combined with action to reduce the number of facilities required to run the business. This has resulted in the amalgamation or shut down of manufacturing plants and sales, service and administration offices.

In lots of organisations, such 're-engineering' is now complete. Having exhausted opportunities to save money by cutting staff numbers and rationalising operations, directors are having to look elsewhere.

Procurement is the obvious place. This is because the value of bought-in goods and services is usually a high percentage of turnover or revenue. The amount can vary from as little as 30 to up to 80 per cent. Typical examples include:

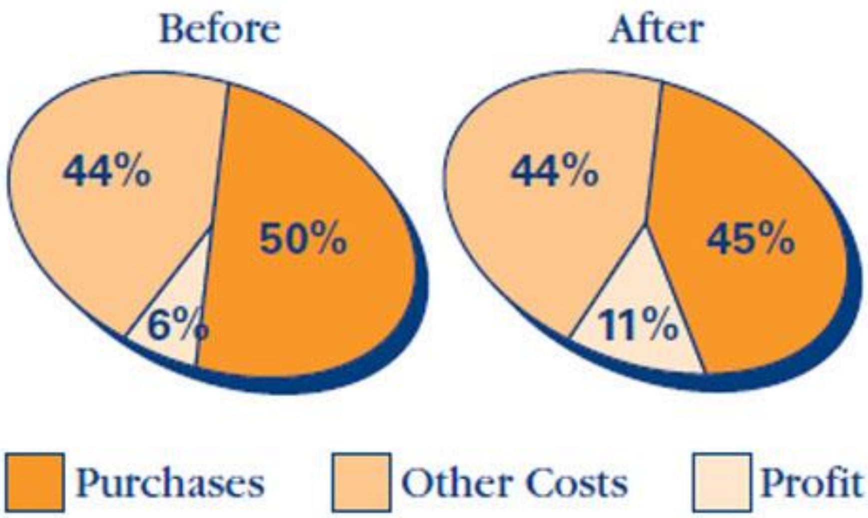
- General goods manufacturing and retail – 65 per cent to 70 per cent
- Electronics and aviation – up to 80 per cent
- The process sector (pharmaceuticals, oil and food industries) – 30 per cent to 40 per cent
- The service sector (banking and insurance) – 30 per cent to 40 per cent

In both the process and the service sectors, the values will normally equal, if not exceed, the amount spent on payroll and facilities.

In the public sector, expenditure on goods and services can typically exceed 50 per cent or more of total expenditure.

It is clear, then, that cutting the cost of in-bought goods, services and capital items can make dramatic improvement to an organisation's bottom line. As an example, the pie chart below shows average cost of supplies, other costs and profit as percentages of turnover in a typical company.

A simple calculation shows that if the company in our example saved just 10 per cent of its total spend on purchases, its profit would increase by five per cent of turnover, nearly doubling to 11 per cent. Cost savings fall straight to the bottom-line.



Creating value, improving effectiveness

Raising the standard of purchasing and supply management can create benefits far beyond price reductions for goods and services. In many instances, it is the ability to get suppliers and the supply chain to perform in ways that serve the purchasing organisation better that provides the real benefits.

E Procurement Can Help

- Electronic ordering and payment systems cut processing costs and shorten delivery times
- The internet can help to identify alternative supply sources and increase bargaining power
- Systems integration can improve stock control and accelerate new-product development
- Online databases and order-tracking can improve customer services

Few things illustrate this more than building and refurbishment contracts. Suppose, for example, you are a retailer, about to refurbish your sites. You want the work to be done well to guarantee the maximum long-term return on your investment, but you want your outlets to be able to re-open as soon as possible.

By carefully evaluating the supply market, by inviting the right companies to tender for your business and by working together with the selected contractor, you can get the value for money you need and keep the number of lost trading days down to a minimum. Conversely, if you fail to manage the procurement process in this way the project is likely to drift on, incurring more costs and losing you more money.

Making a Meaningful Cost Comparison

- What is the total cost of ownership?
- Have we done any coherent cost-benefit analysis?
- Have we more than two offers to compare?
- Are we comparing like with like?
- Do we understand the true cost drivers?
- Are we selecting an economic order quantity?
- Can we split the business and cherry-pick the best options?

Good relations with suppliers also enable existing products to be improved or enhanced and new products or services to be brought to market quickly and efficiently. In some cases, suppliers can be brought into the product-design process. A kind of technology transfer can take place, whereby purchasers and suppliers swap skills in order to achieve product innovation. The international audio equipment manufacturer Bose, for example, has used supplier-in-plant personnel as authorized links between its design teams and its suppliers. This has allowed it to free members of staff for other purchasing duties such as communications and material cost reductions.

If your suppliers are your partners, you can introduce joint cost-cutting initiatives. The UK DIY retailer, B&Q, for example, is renowned worldwide for trying to eliminate packaging waste in its supply chain. This not only saves everyone money – packaging and transportation costs both fall – but also helps the company fulfill its pledge to the consumer to be environmentally aware.

The purchasing and supply management challenge

The purchasing and supply management process will only deliver optimum benefits if it is a coherent whole, if the disparate and often dispersed people involved in purchasing decisions work together for the good of the organisation.

You cannot simply bolt-on a discrete purchasing and supply management function and hope for the best. Nor can you assume that the diverse groups involved in the procurement process will come together naturally to work things out – experience shows that each function pursues its own interests to the exclusion of others.

A coordinated, boardroom-led approach is needed – otherwise supply failures and excessive costs are likely to result.

Purchasing and supply management decisions must be consistent with the organisation's objectives, culture and ethos and be compatible with its structure and geographical reach. The board should resist jumping on the bandwagon of purchasing fads and fashions and rather ask: does this suit us?

The Board View of Procurement

- The primary operational role for procurement is to guarantee security of supply
- Value for money and life time cost is more important than rock-bottom price
- Exclusivity should often be sought with strategic suppliers
- Professional procurement should be able to both reduce the cost base and achieve competitive advantage
- The management of internal and external relationships must be consistent with strategy and ethos

There are many types of purchasing and supply management strategies. Good purchasing and supply management people use the right ones, at the right times.(See box: The key purchasing and supply management tasks.) And they usually discharge their responsibilities best by working within cross-functional teams.

The Contents of a Good Deal

- Service level agreements must be consistent with your business objectives and customer needs
- Continually compare the performance of your suppliers with that of their peers
- Make the terms of the contract clear, precise and comprehensive – get expert advice – and cover your risks
- Include clauses that protect intellectual property
- Ensure suppliers place equal focus on service, process and cost reduction
- Use a firm specification or statement of requirements

Getting started

Re-orienting purchasing and supply management in your organisation is not easy. It takes time and demands commitment and might require investment in training and technology.

The starting point is a review, an audit of current procedures.(See Fifteen Questions for a CEO checklist for example). Once such a review is complete, you can decide on the action that needs to be taken and start to move forward.

Conclusion

Effective purchasing and supply management helps organisations to win – and sustain – competitive advantage. Provided it is, from the outset, backed by the very top, upgrading the purchasing and supply management process can be one of the best investments an organisation ever makes.

Executive Summary

- Organisations spend between 30-80 per cent of turnover with suppliers on goods and services
- Improvements in purchasing and supply management will have a direct impact on the bottom line and on service and on reputation
- Only a co-ordinated, boardroom-led approach will deliver optimum benefits
- Purchasing and supply management must be an integral part of organisational strategy

Managing Supply-Side Risks

In recent years, the management of risk has moved up the corporate agenda. The 1999 Turnbull report on UK corporate governance made it clear that a company's systems of 'internal control' should cover not only major financial risks but also risks arising from legal, health and safety, reputational and environmental issues. The Sarbanes Oxley issues have only brought corporate governance and risk issues into greater light.

The supply chain is often where the different kinds of risks converge. Loss of supply has serious commercial consequences; defective goods are threats to product safety and, therefore, legal liabilities; sourcing policies have clear implications for the environment and for society at large, and the potential to damage a company's image and reputation, Effective purchasing and supply chain management is, then, at the heart of organisational risk control.

Defining risk management

Risk management demands that directors ask,'What if?'. But it is not the same thing as risk-aversion. It accepts risk as a fact of business life – and looks at how it can best be handled.

It consists of three distinct, but inter-related disciplines: risk analysis, risk assessment and risk mitigation.

Risk analysis
This identifies all the things that might go wrong with a project or activity and looks at the probability of each happening.

Correctly undertaken, risk analysis is a vital component in effective management, allowing all risks to be recognised and objectively assessed.

The complexity of the analysis should reflect the complexity of the project. High-value, high-risk projects such as IT-systems procurement clearly require detailed work.

Usually, it is convenient to categorise technical risks and financial risks in terms of their likely probability. Risks that cannot be easily controlled or managed might need to be insured against. It is important, though, that the insurance policy does not come to be seen as a risk-management substitute. Insurance claims are undesirable – a risk in themselves. Staff need to be encouraged to take great care of high-value, business-critical goods and services – in much the same way as they need to be encouraged to take health and safety issues seriously.

Risk assessment
Risk assessment calculates the probable impact of a risk on an organisation. It is therefore crucial in determining risk-avoidance and risk-mitigation strategies.

Preventative efforts will need to be directed towards the highest-impact 'events'. These are often those that are statistically least likely to occur. In particular, there will need to be disaster recovery plans in place in the event of terrorist attack, arson, flooding, etc.

Risk mitigation
This is the actual anticipation of risk. It will involve contingency planning and the identification of those parties best able to manage the risks concerned. It will ensure that the right people have the right powers to mitigate risks.

Purchasing and supply management risks

Security of supply
A breakdown or interruption of key supplies can result in operational break-down (eg. Halted production lines), increased costs and damage to a brand or a corporate reputation.

Managing Supply Risk

- Directors have a duty to stake-holders to control purchases and manage reputation
- Dependence on any one supplier is dangerous
- Sourcing policies must reflect corporate social responsibilities

- Professionally drafted contracts help to minimise risk exposure

To manage the risk is, fundamentally, to manage supplier relationships. Detailed and thorough supplier appraisal procedures are advisable. Beware of suppliers with potentially serious financial problems: they are very likely to let you down.

In general you should look for suppliers whose approach and ethos are broadly consistent with your own. A 'cultural fit' greatly improves the chances of effective communication – and, therefore, of minimal supply and demand problems. Working in partnership with you, your key or strategic suppliers will be able to alert/help you to anticipate potential risks within the supply chain.

Effective supplier relationships require a delicate balancing act. Ideally, you should be close to your suppliers without being dependent on them. Over-reliance on any one company significantly increases supply-side risks. Have contingency plans in the event of supplier failure – research the market. Do not have all your eggs in one basket; try to spread the risk.

When to Partner?

- Low-value contracts demand little interaction between buyer and seller
- Partnership approaches are appropriate only where there is the potential to win competitive advantage or exclusivity
- Effective partnerships depend on trust, transparency and the willingness to share risks
- Long-term arrangements might conflict with the interests of lenders and/or shareholders?

Organisations faced with the possibility of a dangerously high level of supplier dependency can be tempted to transfer the element of risk to the supplier. This, however, can be a risk in itself; the supplier may react by raising prices.

Risk transfer will only work if the third party has some degree of control over the eventuality. Some organisations make the mistake of offering incentives or rewards to suppliers to take on risks they can do nothing about.

Quality

Quality control is a big part of risk control. If externally acquired inputs are not up to standard, an organisation's outputs will suffer. The results can, again, be operational breakdown, increased costs and damage to reputation/brand. Effective sourcing strategies will mitigate the risks.

Information 'asymmetry'

When one party to a contract knows more than the other a dangerous power gap can arise.

There is a measurable degree of risk in dealing with suppliers who have more knowledge of the product than you do – and who make use of this knowledge to charge higher prices, for instance.

The purchasing organisation should try to eliminate this imbalance by being fully familiar with the product and its position in the marketplace; in this context, joint product development initiatives with the supplier can be seen as a risk-mitigation strategy.

Outsourcing
Outsourcing non-core activities can bring significant operational benefits - not least reductions in costs, but it can also create further risks. The three main areas of risk are:

- loss of control
- loss of intellectual property
- damage to brand/reputation

Outsourcing Considerations

- A function should only be outsourced if there are clear business or strategic reasons to do so
- Clear understanding of internal operations, of strategic goals and of customer needs is vital
- Clients must be thoroughly assessed. Specific outsourcing-related risks
- Outsourcing projects must be actively managed as an iterative process
- Are we clear on total cost of ownership?
- Do we need to transfer staff?
- Have we a clear idea on the impact of outsourcing on direct, variable, and fixed overheads?
- Do we know our own business well enough to outsource the model for greater efficiency?

The sportswear manufacturer Nike fell foul of outsourcing risk several years ago when it handed some of its manufacturing to overseas sweatshops. The damage to its good name was considerable.

To mitigate the risks involved in outsourcing, research potential contractors thoroughly. And make sure you stay close to the project or operation. Remember that outsourcing is a way of delegating responsibility – not abrogating it. Ultimately, you remain in charge.

Regulation
Organisations must comply with the regulatory environment they operation in. Failure to do so can result in court action and be a serious reputational risk.

In recent years, regulations from both the UK and the EU have addressed issues such as the triple bottom line – a company's responsibilities to the environment and society as well as the economy – and corporate governance. A company is now, more than ever before, expected to act ethically. This raises important supply-side questions. Should it buy goods, services or capital items from companies that pollute the environment or waste the world's resources?

Whether you care about such issues or not, you cannot ignore their significance. They represent significant reputational and, therefore, commercial risks. Purchasing and supply management policy must reflect this reality.

Contracts
The agreement made between an organisation and supplier is of critical importance. Poorly and unprofessionally drafted, it will increase risks. Correctly and professionally drafted, it will be an effective risk-mitigation tool.

The contract should provide an early definition of the relationship between purchaser and seller, stipulating what is expected from both parties. If one of the agreed aims, for example, is to work together to reduce product costs, this should be clearly stated.

Crucially, the contract should give a precise indication of renewal dates and of notice periods. The purchaser should be able to terminate the agreement in a reasonable and fair timeframe.

Key Risk Management Tasks

- Identify and promote the business need for risk management in the purchasing and supply management process
- Identify who within the organisation has responsibility for risk management
- Help to analyse and assess the risks
- Be well-informed about the supplying organisation(s)
- Be fully conversant with strategies for minimizing risk at the contract-drafting stage
- Capture the benefits of better risk management –reduced waste, better focus, more stability, better value for money, less crises.

For significant contracts, a business case should be made, detailing the reasons for the investment and the expected return. This is a kind of due diligence process – without it, the risk that money will be squandered greatly increases.

At the pre-contract stage, it is often useful to ask bidders to state in their tender documents which risks they would be willing to take responsibility for; these can then be the subject of negotiations during the bid clarification process.

Risk from the suppliers' perspective

Remember that risk management is not the preserve of the purchasing organisation. If a supplier perceives a risk to be present (for example, uncertainly about their suppliers or doubts about any of their customers) then they will build in a safety margin. This will obviously have cost implications for their trading partners.

Conclusion

Effective risk and reputation management should be embedded in the organisation's culture. It should be clearly defined responsibility in day-to-day decision-making.

Regular monitoring will be necessary to ensure the mitigation methods remain effective.

Executive Summary

- More risks mean that better risk management is now needed
- Risk analysis is an essential component of good management
- The supply chain is the best place to mitigate risk
- Security of supply is the primary responsibility for buyers
- Spread risks by dual-sourcing
- Outsourcing can create risk
- Contracts are key and often need professional input

Appendix I - Fifteen Questions for a CEO

1. Do you know how much your organisation is spending externally?
2. If yes, do you know how much is spent on each category of spend and with which supplier?
3. Do you know the total life-cycle cost of the purchases you make, rather than just their price?

4. Do you know how much value your suppliers provide and create for your organisation's success and reputation? Which are business critical?
5. Do you know who your key suppliers are, your top ten for example?
6. Do you have pro-active, close relationships with your strategic suppliers?
7. Do you understand the risks inherent in the purchases you make and are you managing them effectively?
8. Do you know what you should outsource and what you should not outsource, and why?
9. Are you outsourcing services successfully? How do you know?
10. Do you know what your purchasing strategies are? Are they aligned to your business strategies?
11. Do you have appropriately skilled people developing and managing your purchasing strategies?
12. What proportion of your external spend is managed or overseen by your purchasing professionals?
13. If the answer to the last question is not 100 per cent, why not? And, what are you doing about it?
14. How do you support your purchasing people to ensure they achieve appropriate business benefits? How do you know they are doing a good job?
15. Do you direct your purchasing people to limit their focus to reducing prices by x per cent each year or do you direct them to achieve cost-effective, risk-controlled added value?

Appendix II - Benefits of Effective Purchasing and Supply Management

- Lower costs and better value for money
- Security of supply – certainty that vital raw materials and components will continue to flow to the organisation
- Better risk control – sourcing policies that do not damage the company's reputation, conflict with social and environmental responsibilities or contravene legislation
- Leverage – the ability to negotiate better deals from suppliers
- Quality improvements – supplier relationships that make products and services better and reduce time to market
- Process efficiency – the use of electronic and technological tools to improve ordering and related processes

Appendix III - A Chief Purchasing Officer's (CPO's) Template Job Description

- Ensure the purchasing and supply management perspective directly relates to business needs
- Select and implement the appropriate strategies to support the organisation's goals
- Advise on, and help to implement, strategic changes such as mergers and acquisitions making sure synergies are exploited and the maximum commercial leverage obtained
- Arrange appropriate outsourcing of corporate services – with the objective of delivering significant quality improvements and reductions in costs
- Set continuous targets for improvement, providing training for colleagues and those with significant purchasing responsibilities
- Use a range of tools, methodologies and approaches that can add significant value to the organisation with year-on-year improvements

- Keep up with developments in purchasing and supplying management through networking
- Keep abreast of new techniques
- Employ good, professional people in appropriate roles and support their continued development
- Implement efficient information systems so you know what you spend, with whom and on what, to maximise performance
- Ensure you have clear authority levels, policies and processes so procurement is transparent and well-managed
- Secure ‘buy-in’ from colleagues and senior decision makers

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