PROCUREMENT AND SOURCING FOCUS

Tips for Quantifying Savings from Supply Management

SCDigest Editorial Staff

Most sourcing and procurement professionals know how difficult it is to accurately quantify the real value if their work.

P. Fraser Johnson and Michiel R. Leenders, of the University of West Ontario and the Richard Ivey School of Business, respectively, have recently offered some excellent insight into that topic in a new article for MIT's Sloan Management Review. A few weeks ago, we summarized their thoughts on the challenges of accurately calculating the real value of supply management and the harm to companies from either under or over-estimating that value. (See The Challenge in Quantifying Savings from Supply Management.)

This week, we look at their recommendations on how to best overcome those challenges. In the end, Johnson and Leenders say, getting that number close to right not only serves the cause of the supply management function within a company and the professionals who practice the craft there, but actually helps to maximize those savings to the company by eliminating barriers or mis-incentives that can get in the way of optimal performance.

They offer three strategies for more accurately calculating supply management value and getting more of the total savings that may be available:

1. Focus on the Total Cost of Ownership: This is something of a "holy grail" for the supply function, in which both procurement professionals and their internal "customers" would focus on total supply chain cost - not just purchase price.
"Don't call the results "supply savings." The richest opportunities for supply savings originate from cross-functional efforts and coordination," Johnson and Leenders say.

Simply put, supply managers must be prepared to replace their frequent focus on purchase price savings and take aim instead on total supply chain savings. This requires giving credit to others in the organization who contribute to major supply initiatives, in such areas as engineering, manufacturing, etc.

The authors say, for example, that one consumer packaged goods company shifted its procurement team's focus from the lowest price to achieving the the best total value. That encouraged teams to consider trade-offs between manufacturing uptime, price and delivery consistency, inventory levels and obtaining and retaining retail shelf space. Since team members were evaluated on team results, individuals had every reason to work together, and ultimately expanded the role of supply management within the company.

2. Categorize the Different types of Savings: It is a mistake to try to come up with a single number that reflects the total "savings" that were achieved say annually by the supply management function, Johnson and Leenders write.

Supply management-related savings "can come from cost avoidance or year-over-year cost reductions," they note. "They may be the result of improvements in per-piece prices, working capital, variable costs, fixed costs, capacity, quality, sales revenues and margins."

Companies should begin by establishing a set of rules inside the supply area for what constitutes a reportable savings, when and how savings are to be reported and what role savings play in the objectives and management of the supply organization. Those rules should be "published" to get support and buy-in from related functional areas and company executives as appropriate. That would include retails on how the "savings" will be calculated, categorized, and reported/distributed.

Johnson and Leenders suggest a simple format for doing this, though they stress there are any number of other structures that may make sense for a given company:

- Market fluctuations: Savings that are really the result of market price changes, but that nonetheless are important to communicate
- Routine supply efforts: Price and total cost of ownership savings are to be expected from efforts of supply professionals in their daily work
- Cross-functional initiatives: Reported only when the any such initiatives are completed
- Cost containment or avoidance: Basically, savings or cost avoidance that are the result of actions or strategies that go beyond routine (for example, pre-buying before a large market price increase)

While such reports might typically be quarterly with an annual summary, major savings in any category should be reported immediately.

3. Hardwire supply Savings to the Budget: This is the most interesting and perhaps controversial of the three recommendations.

The recommendation is made, the authors say, because the savings that should be achieved from supply management efforts often don't make their way to the bottom line. An example would be negotiating a new national contract with a supplier, only to have local managers continue to buy locally. Not only does this negate the real benefits of the supply management effort, it can lead to internal disputes about what was "saved" and what was not.

It is a mistake to try to come up with a single number that reflects the total "savings" that were achieved say annually by the supply management function.

"Skeptics can be silenced if the savings claims are directly linked to budgets and spending. Four companies in our study created new financial controller positions with responsibility for validating savings and linking cost savings to business unit operating budgets," Johnson and Leenders say.

That doesn't have to mean a complete dollar for dollar impact on budgets from the theoretic savings. There often is some level of acceptable "leakage." There should be consultation with various business managers about what the real budget impact should be, and if in fact some of the "savings" might be used to invest elsewhere (e.g., marketing) - though there needs to be a process for making those adjustments.

"Although there is a certain amount of guesswork, the chief supply officer should be able to determine with relatively little analysis whether a reported saving is realistic, whether the estimate is overstated or understated and why a gap exists," Johnson and Leenders conclude.

"In addition, it's important for supply executives to have a system for reporting what happened to savings after they were achieved. Did they flow to the bottom line, where they could be used to provide lower prices to customers, purchase additional equipment or offset cost variances in budgets? Or were savings redirected along the way to advance strategic priorities, such as market share growth, new products or services or professional development? Without this information, it is difficult to assess the full savings impact."

Do you agree with Johnson **and Leenders' recommendations** for improving the reporting of supply management's value? What would you add? Let is know your thoughts at the Feedback button below.

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