

Show me the money!

Whether they like it or not, purchasers' effectiveness is judged by the cost savings they make. But measuring those and proving their validity to senior management has long been an uphill struggle. Geraint John looks for signs of progress

Question: when is a cost saving not a cost saving?

Answer: when the purchasing department claims to have made it. It's a cynical view, but one that is widely shared in many organisations. And for a profession whose credibility depends on its ability to deliver sustained cost reduction, this perception is both hugely damaging and a brake on its ambitions.

"Unless purchasing is delivering significant savings, all its other work is devalued," says Ian Taylor, head of group procurement at HBOS, the company formed by the merger of Halifax and Bank of Scotland. "The worst thing that can happen is for its savings claims to be discredited."

Although demonstrating cost savings may sound like a relatively simple exercise, in reality it's a problem that purchasing practitioners have been grappling with for years, without ever quite cracking. Every purchaser seems to have a story of skilful negotiations producing a healthy paper saving, only for it to get lost somewhere along the way and never make it to the bottom line.

The expectations raised by e-procurement, and its mostly disappointing record so far, have added to the pressure on purchasing. And with a backdrop of economic slowdown and intensifying global competition, it's hardly surprising that performance measurement is once again a hot topic for the profession.

"As more organisations realise that procurement matters and has strategic importance, so the need to measure its performance grows," says Roger Keeling, a senior consultant with the PMMS Consulting Group and former purchasing director at Whitbread and British Rail.

As a result, he adds, the sort of input-based measures traditionally used in purchasing - headcount per £1 million of spend or the number of transactions handled by each buyer annually, for example - have become less satisfactory. "Those things are relatively easy to measure, but they really only tell you about the efficiency of the purchasing department, not what contribution it makes to the organisation."

Output-based measures, which focus on things such as price savings, supply base reduction and supplier service levels, are more useful, says Keeling. "But they are still a rear-view mirror: they tell you where you've come from, not how well you are doing or where the new opportunities might be." What is really needed, he argues, are measures that reflect the total cost of ownership and the purchasing process, which can then be benchmarked against external best practice.

Of course, the rear-view mirror criticism is hardly unique to purchasing. It also aptly describes the financial indicators that have long dominated the way organisational performance is measured. In the 1980s and 1990s, these measures came under a sustained attack from those who argued that not only were they backward-looking, but in an era where intangible assets (knowledge, people and brands) were becoming more important than capital assets, balance sheets simply didn't reflect the true value of modern companies.

This resulted in the development of a number of new measurement systems, covering both financial and non-financial elements. On the financial side, some organisations have replaced traditional accounting with activity-based costing, which attempts to measure where

costs are incurred in a production process. And broader corporate measures, such as economic value-added (EVA), have become popular with stock market analysts as a means of determining how well companies are performing for their shareholders.

Arguably the most influential model has been the balanced scorecard, first set out in a Harvard Business Review article by Robert Kaplan and David Norton in 1991. The balanced scorecard aims to overcome the inadequacies of a purely financial approach by adding customers, internal processes and innovation and learning to the measurement mix. In doing so, it provides a strategic framework that enables an organisation to look at how well it serves customer needs.

For purchasing, the model has the advantage of both recognising its qualitative contribution - for example, in automating the requisition-to-pay process and developing supplier relationships - and linking this to business objectives. "It can be an extremely useful tool," says Keeling. "All of our clients that have upgraded their purchasing in the past four or five years have used some form of balanced scorecard."

"I'm a fan of the balanced scorecard," adds Taylor. "I haven't come across anything better in 10 years of looking at measurement."

Nevertheless, adopting the balanced scorecard does not in itself solve the problem of how to capture quantitative savings and convince senior management of their validity. Despite all the talk about more holistic performance measures, pressure from institutional investors means that a short-term mentality - symbolised by the quarterly

Show me the money!

reporting of results - still prevails in financial markets. In such an environment, it is understandable that chief executives and finance directors demand of purchasing what Cuba Gooding Jr's character in the film Jerry Maguire demanded of his agent, played by Tom Cruise: "Show me the money!"

This can be extremely difficult, because while genuine savings may have been achieved, they are cancelled out by other functions. "The direct contribution of purchasing to the bottom line is very hard to measure," says Professor Arjan van Weele, chair in purchasing and supply management at the Eindhoven University of Technology. "People on the sales side often use savings to reduce prices and increase their hit rate. So savings don't necessarily equal extra profits."

A serious stumbling block in overcoming this problem is purchasing's relationship with finance. Not only are their respective IT systems often not fully compatible, says Malcolm Smith, managing director of CIPS's Corporate Partnership Programme, but their information needs can be quite different. "Take the manufacture of glass bottles," he says. "Finance is only interested in the cost of the glass that goes into them and the value of the finished product, whereas purchasing wants to know about different specifications and the performance of various suppliers. It's difficult to reconcile the two needs."

But that's no excuse for not trying, Smith believes. "Whether we like it or not, finance provides credibility and, as purchasers, we have to piggyback on that. In the past, we haven't nurtured the financial community as well as we should have done."

Ian Skinner is one man who can relate to that. Before taking charge of indirect purchasing in Europe for photographic giant Eastman Kodak in November 2000, he spent 27 years in finance, where he was sceptical of purchasing's cost-cutting claims. He saw his move as a chance to improve things.

"The first problem is agreeing a definition, because it's difficult to identify year-on-year cost reduction in a non-manufacturing environment," he explains. "The second is tracking savings to the bottom line. We've clarified our definitions, but it still isn't easy to prove the savings."

For Thomas Rinn, a senior project manager with Roland Berger Strategy Consultants in Stuttgart, one reason for this is that purchasing doesn't talk finance's language. "Chief financial officers don't use the word 'savings' very often, because there isn't a line for it on the balance sheet." What they want, above all, he says, are figures that fit with their company's preferred financial reporting system, whether that be earnings before interest and tax (Ebit) or EVA.

Reporting savings in a way that conforms to Ebit is not that difficult, he says, but it does require a change of mindset. This is because instead of reporting a cost saving as a single lump sum, say £20 million, it has to be spread over a period of years. The savings look even less impressive under Ebit's close cousin, Ebitda (earnings before interest, taxes, depreciation and amortisation). But the benefits for purchasing of adopting this approach, Rinn believes, far outweigh the lower numbers. "With Ebit, acceptance of the savings from finance is almost guaranteed," he says.

EVA is another matter. Although it is a better measure for purchasing, says Rinn, "because it covers 99 per cent of the things it can influence", EVA is also a notoriously difficult one to understand (being defined as net operating profit after taxes minus capital times the cost of capital). He knows of two German companies that are currently trying to report purchasing results using the EVA formula, but says they are struggling. "In my opinion, they will end up using Ebit and getting finance to translate the numbers into EVA."

Rinn's argument is one that rings true for Jean-Pierre Rouffet, head of global purchasing at Aventis CropScience. Over the past year, he has concentrated on trying to demonstrate purchasing's impact not on "savings", but on free cash flow - a key measure for both financial directors and analysts. "Free cash flow is a bridge to talk to finance and others in our business," he says. "It's one of the very few indicators that I have had positive feedback on."

Increasing payment terms for suppliers is the classic means of improving cash flow, but one that is hugely unpopular. So instead, Rouffet has focused on better management of inventory and improving the quality of capital investment decisions by auditing them thoroughly before any money is spent.

"I calculated that purchasing had less than a 1 per cent impact on free cash flow, which is ridiculous," he says. "By doing things differently, I think we can impact more like 10 per cent." For a firm that spends £1.2 billion a year, this could translate into significant cost reduction, or at least avoidance.

Show me the money!

However, making a greater effort to talk finance's language need not mean bowing to its every word. Didier Dobrodziej, purchasing director at SKF, the world's leading producer of ball bearings, notes that senior management tends to look at the "landed" cost - headline prices plus the cost of transportation, duty and packaging - rather than the total cost. This sends the wrong message not only to purchasing, he believes, but to the rest of the business as well.

At the beginning of 2000, Dobrodziej put into practice a total cost of ownership model that incorporates four other tangible metrics: the costs of one day of inventory, quality non-conformance by suppliers and delivery failure, plus the saving gained by increasing payment terms by one day. The aim is to have a measure that complements cost-reduction targets and enables professional buyers and factory managers alike to decide which is the best supplier to place business with at a particular time.

While this model doesn't help to solve politically sensitive make-or-buy decisions - Dobrodziej's next challenge - it does at least give a more rounded picture of the external supply market. "I no longer have to convince people which suppliers to use," he says.

Günter Fuhry, co-leader of McKinsey's purchasing and supply management practice in Europe, is another advocate of broader measures. Purchasing, like other functions, tends to measure what is possible within organisational boundaries, rather than what matters to the business overall, he says. "It's better to measure the right things 80 per cent right than the wrong things 100 per cent right."

One of the most common mistakes, according to Fuhry, is only to track purchase price improvements over time. In many industries, this has little value because prices are falling fast and specifications are ever-changing. Instead, he argues, purchasing should focus on paying for performance: looking at what a product contributes, rather than merely its specification. This helps to avoid looking at cost in isolation and consider wider business issues - for example, is the end customer willing to pay a higher price for better quality or performance?

Taking this approach inevitably requires closer co-operation with other functions, such as design, engineering and marketing, and ultimately an acceptance of cross-functional performance measures. An impediment to this is the fact that, when it comes to cost savings, purchasing is often criticised for claiming the credit for successes that, at the very least, ought to be shared.

At the financial services firm Prudential, all savings claims have to be signed off by an internal customer before they are presented to finance. "Ideally, savings targets are built into people's budgets upfront," says Clive Heal, its head of group procurement. "If not, they have to be audited robustly afterwards."

Purchasing's involvement in the process of setting budgets may be preferable from a cost-saving point of view, but it's hardly one that wins it many friends, especially when the result is lower budgets. "The challenge," says Heal, "is to create an environment where people want to reduce their own budgets." That can only be done by building good working relationships and trust over a period of time.

Of course, in order to report good results, you have to achieve them. So it's vital not to overlook the need to motivate staff within the purchasing team. Managers often fail to communicate clearly what the key objectives are, and hence what measures are important, says Elda Simonaska, research associate at the European Institute of Purchasing Management in Geneva. "There tends to be a lot of frustration at the operational level. Buyers may not understand the purchasing strategy, let alone the business strategy. So they don't know why they are being asked to do certain things."

Equally important, adds Professor van Weele, is the need for purchasing leaders to demonstrate a passion for improvement. "Performance measurement requires healthy ambition and a large number of training hours," he says. Objectives for improvement should be a mutually agreed contract between the manager and the buyer. "And there must be a link between pay and performance. Very few companies do that well."

Getting the right balance of hard and soft measures, those that track efficiency and those that show effectiveness, and between internal organisation and external market factors, is a challenge not just for purchasing, but for businesses as a whole. And while finding solutions to the cost savings issue may not turbo-charge the profession's reputation, they will surely propel it in the right direction.

Show me the money!

Analysis

The e-procurement dimension

One of the benefits of modern information systems is that they enable managers to collect and analyse performance data. At the same time, their often high cost means added pressure to prove that promised benefits are being delivered. In the case of e-procurement, this raises the question of whether traditional purchasing measures are adequate or whether new ones are needed.

For Stuart Dodds, a senior supply chain consultant at Accenture, the answer is broadly that the old ones will do. "Just as e-procurement essentially supplements rather than replaces traditional procurement processes," he says, "so e-procurement metrics are not significantly different from those used in a traditional environment."

Some new key performance indicators may be necessary, particularly around e-auctions. But his main message is that purchasers need to get measures in place quickly and ensure that they distinguish between implementation success and business benefits.

Examples of the former include the number of users registered on the system or the percentage of purchasing transactions made electronically; whereas the latter include price reductions offered by suppliers because of increased efficiency and higher volumes, or the time taken to complete a tender process.

Checklist

Measurement must-dos

- Don't pick too many metrics - a dozen should be more than enough.
- Make sure you are measuring the right things - do they demonstrate effectiveness of outcomes or merely efficiency in the purchasing function?
- Ensure that your chosen metrics are aligned with 1) your purchasing strategy, and 2) business objectives.
- Communicate objectives clearly throughout the purchasing team, and make sure everyone understands - and accepts - their part in meeting them.
- Work closely with other functions, such as human resources, to produce sensible ways of rewarding good team and individual performance.
- Senior management wants hard numbers, so concentrate on agreeing a way of measuring cost savings that satisfies both their needs and those of other functions.
- Keep management reports short and include only those measures that will be of interest to those outside purchasing.
- By all means benchmark your performance externally. But satisfy yourself that the data is robust and the comparisons relevant, and don't just try to imitate others' practices.