

Procurement has no part to play in corporate strategy – myth

A Guest Article by Bryan Duggan
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The five key roles of procurement

Most business schools and MBA programmes relegate procurement to being a mere subset of operation management. Progressive businesses, however, recognise five areas in which procurement has a significant part to play in overall business strategy.

Bearing in mind that businesses can spend, on average, anything between 40% and 80% of every £ earned from sales revenue on bought-in goods and services, the impact that good procurement can have is significant.

The five key areas of impact are:

1. Immediate effect on profitability
2. Risk management
3. Alignment of procurement strategy with overall business strategy
4. Innovation
5. Financial and organisational control.

Procurement efficiency benchmarks

So how do we tell if a business is likely to have efficient procurement?

The established benchmarks for procurement efficiency are:

- % of non-payroll expenditure under procurement management
- % of contract compliance (i.e. compliance with the use of cost-efficient contracts that have been set up by procurement for the business).

A 2009 survey of 179 finance and procurement professionals by the Aberdeen Group revealed that the top-performing companies in procurement process had, on average, more than 85% of their non-payroll spend under procurement management and 80% contract compliance.

Effect on profitability

“So what?” you might say. But the results of this investment in procurement go straight to the company’s bottom line. The survey revealed that between 5% and 20% cost savings result from having spend under the control of a professional procurement function.

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Furthermore, the top-performing procurement functions tend to have operating costs that are lower by around 24%, largely because they have invested in automating the procure-to-pay function.

A typical manufacturing business will buy in 65% of its turnover in goods and services. Shaving just 10% of that gives a bottom line profit improvement of 6.5% on sales. The figure for service industries would be 40% and 4% net profit improvement on sales.

Control and visibility of spend

A side effect of having more spend under procurement control and an investment in systems is that the business now has far greater visibility of its total outgoings – making budgeting quicker, easier and more accurate.

Managing business risk

One of the key functions of a professional procurement department is to identify those suppliers that are strategically critical to the business and manage them closely to minimise business risk. Failure to do this can jeopardise the viability of the whole business. Now we call that part of key business strategy!

Results of poor procurement practice

Here are two examples of poor procurement practice that had a dramatic effect.

Case study A: Global airline – flag carrier

The company decided to outsource its in-flight catering to an external provider. In this case it screwed the new supplier so hard on cost that it was going to be impossible for the supplier to make an adequate profit. The supplier started to make redundancies and reduce staff benefits to save costs, which triggered a staff walk-out.

The airline grounded 900 flights, and the unofficial action cost it in the region of £45 million, delays and cancellations disrupting the travel plans of 100,000 passengers. As always, the true cost was probably far higher still, including lost brand image and public confidence in the airline.

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Case study B: Global mail order business

A very large mail order business, whose reputation depended on prompt despatch and delivery, decided to re-tender its parcel delivery service. Thinking it would save money, it chose a large and well-known parcels service that had a poor industrial relations record, over a slightly more expensive but highly efficient competitor.

Just a few weeks into the new contract, the staff of the parcels delivery firm went on a prolonged strike.

The net result was not exactly a cost saving: the entire business collapsed because of the high “distress” cost of alternative delivery arrangements and the delays and loss of business that arose.

Aligning procurement strategy with business strategy

Procurement must be integrated into strategic direction for the business. The best way to achieve this is to have procurement represented on the board.

Suppose that the business needs to change its overall market positioning. Morrisons supermarket needed to do this when it migrated from being a low-cost Northern outlet to a broader based business competing with Sainsbury’s, Waitrose and Tesco.

Morrisons struggled initially to switch its supply chain from cheap and cheerful, low-cost products to being able to offer their “The Best” range to rival Sainsbury’s “Taste the Difference” and Tesco’s “Finest” quality-positioned products.

Morrisons procurement did, however, succeed in making the switch, and this is reflected in the company’s excellent performance of a growth of profit by 21% to £767 million to December 2009 and an overall growth of 6% in sales.

We can now see how critical good procurement can be to business strategy and success.

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Innovation

Smart customers involve suppliers in the early stages of their products' life cycle. Suppliers may provide design suggestions or even be given complete responsibility for the design, engineering and development of the new product.

Involving suppliers in the product development process and using their skills and expertise can reap great benefits for the customer. These benefits include shortened product development cycle times, lower costs and higher-quality end products.

The motor industry is a major exponent of using suppliers for innovation, but it is necessary to first build a relationship of trust – otherwise suppliers will fear handing over their crown jewels only to be exploited. An example of good practice is the development, by Mercedes-Benz with Bosch, of anti-lock brakes for cars. Neither company had the ability to go it alone, but with the two working together, Mercedes-Benz scored a world first – and probably saved many lives into the bargain.

Financial and organisational control

Advanced procurement practice will always involve:

- knowing exactly what is being spent and by whom
- having a high proportion of that spend under managed contracts.

These days, cash management has become critically important for many businesses. Having total visibility of non-payroll spend is a major part of this.

The best-performing businesses will have implemented a complete procure-to-pay process that both captures a very high proportion of the spend and identifies the cost centres concerned. Budgeting becomes easier and more accurate, and the system can be extended upstream to the position of “no contract – no purchase order”, giving near complete control over purchase costs and channels.

If you want to see how your business shapes up to the challenge of modern procurement, look at the quick checklist on the following two pages.

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Assessing the effectiveness of the procurement function

| WEAK | STRONG |
|---|--|
| Strategic influence | |
| Procurement takes no part in strategic decision making. | Procurement is actively involved in business strategy decisions and identifies and manages the strategically critical suppliers to the business. |
| Procurement handles purchase orders but has little influence on spending decisions. | Procurement is represented at board level and is closely involved at the outset in all significant purchasing decisions. |
| Financial influence | |
| Less than 30% of non-payroll spend is controlled by procurement and less than 15% contract compliance. | 90%+ of all non-payroll spend is handled by procurement 80% + contract compliance |
| Quality of people and skills level | |
| Procurement is seen as a backwater, with low-level staff who receive little or no development or training. | Procurement is seen as a key function that is staffed by professionally qualified people who have an active personal development programme. |
| Transactional vs value added activity | |
| Procurement activity is primarily transactional – handling purchase requisitions raised by line managers and expediting deliveries. | Procurement activity concentrates on managing key procurement projects and developing key supplier relationships. Transactions are largely handled by investment in systems. |
| Integration with business operations | |
| Little or no interaction with business stakeholders and other departments. | Regular meetings with business stakeholders who have come to value the involvement of procurement because of its track record of continuous improvement in cost and service delivery. Active representation on cross functional teams. |

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| WEAK | STRONG |
|--|--|
| Management of suppliers | |
| No supplier service level agreements or key performance indicators (KPIs) set or monitored. | KPIs relevant to business need set by liaison between stakeholders, procurement and suppliers, and closely monitored thereafter. |
| Little or no action taken on poor supplier performance. | Immediate action taken on poor supplier performance. A full root cause analysis process that will uncover deficiencies in both the supplier's and the business's own processes. |
| Procurement sets up contracts but has neither the resource nor the skills to manage the contract post award. | Procurement function has contract management expertise. Active management of suppliers post contract award. Acts as the prime interface between suppliers and the business to ensure good performance. |
| Innovation | |
| Procurement has little or no influence on innovation in the business | Procurement champions innovation through identifying and nurturing key suppliers who can contribute new ideas and technologies. Also monitors supply markets and academia for future developments. |
| Risk management | |
| Procurement has little or no awareness of business risk in supply contracts. | Procurement takes the lead in identifying and managing business risk in supply contracts. |

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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.