Critical Issues
REPORT

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Hot Topics in Today's Supply Chain Management

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INDIRECT SPEND

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EXECUTIVE OVERVIEW Indirect spend is receiving increased attention from the senior management of large corporations. This category of spend is the sum of all purchased goods and services that do not end up in products or services delivered to the customer. On average, indirect spend equals 50 percent of a company's purchases. Unfortunately, a significant amount of indirect spend is not purchased using the organization's purchasing/supply function or purchasing processes. Senior management has realized that reducing or eliminating indirect spend offers an opportunity to favorably affect a company's cost structure.

Common examples of indirect spend are: professional services, utilities, company travel, office products, and employee benefits. However, spend that is indirect for one company may be direct for another. Furthermore, segmenting direct and indirect spend can be very difficult, particularly for service companies.

In general, companies that are focusing on indirect spend are attempting to reduce it by improving data collection, using electronic catalogs and purchasing automation systems, increasing the centralization of the purchasing organization, and implementing improved processes and systems.

In April 2003, CAPS Research, in partnership with Lucent Technologies, hosted an indirect spend workshop. The intent of this workshop was to define, discuss, and develop the good/best practices in the area of indirect spend. The workshop was centered on four case studies. Each presentation was followed by a group discussion of the case and the lessons learned.

For the purposes of this paper, indirect spend is defined as: *Any purchased good or service that does not end up in the product or service delivered to a customer.*

Though each of the four case studies offered different methods for controlling indirect spend, they were complementary. The four cases can be summarized as:

- Organizing for indirect spend management
- Implementing systems to aggregate and leverage indirect spend
- Activity-based target costing for services
- Outsourcing the purchasing/supply function for non-strategic indirect spend

Based on these presentations and the discussions that ensued, nine enabling tactics were identified. The tactics, used individually or collectively, can assist a company in managing and controlling its indirect spend. The nine tactics are:

1. Zero-Based Budgeting
2. Pre-Budget Savings
3. Organizational Structure
4. Accounts Payable Part of Purchasing/Supply
5. Training Power Users
6. Supplier Managed E-Catalogs
7. Commodity Coding for Indirect Spend
8. One Commodity Team for a Large Supplier
9. Outsourcing Indirect Spend

As is true for most change management efforts, steadfast upper management support is one of the most important aspects of managing and controlling indirect spend.

INTRODUCTION Over the past five years, purchasing/supply groups in well-managed companies have made great strides in reducing the price of inputs. Since specific direct materials are often associated with distinct Strategic Business Units (SBUs), managing this spend is usually accomplished through center-led commodity groups, with sourcing decisions and administration occurring at the SBU. Though most companies are generally satisfied with the efforts they have made in strategically sourcing their direct goods and services, most companies are still attempting to gain comparable control and results with their indirect spend.

For the purposes of this paper, indirect spend is defined as: *Any purchased good or service that does not end up in the product or service delivered to a customer.* Common examples of indirect spend include professional services, utilities, company travel, office products, and employee benefits.

With increased outsourcing of non-core capabilities, the growth of the service sector, and increasing cost pressure, the importance of managing indirect spend is increasing. However, due to the localized control of most indirect spend, the problem is more complex from a managerial and administrative standpoint. Issues often arise in segmenting indirect spend across or between different functional areas. Another common problem is that indirect spend may be hidden in the price of direct materials. For example, if a supplier pays for shipping, the transportation cost (indirect service) is buried in the cost of the direct material.

To address these problems, companies have started to look for methods to identify, manage, and reduce their indirect spend. These methods fall into one of two categories: internal and external.

If indirect spend is to be leveraged, effective data collection and consolidation is critical.

INTERNAL METHODS To date, the most important internal measures have been collecting and consolidating data to facilitate leveraging, restructuring the purchasing organization to establish indirect-spend accountability, automating the requisitioning/purchasing process, and standardizing what is bought.

Data collection and consolidation:
Sometimes, several units within one organization often unknowingly purchase the same goods and services from different suppliers (or even the same supplier) at different prices. In this situation, the corporation suffers due to loss of potential leverage with suppliers.

If indirect spend is to be leveraged, effective data collection and consolidation is critical. Company management must have a clear understanding of what goods and services are being purchased by individual SBUs. Once the overall spend is recognized and analyzed, the company can then identify goods or services that might be channeled through one or two suppliers to achieve maximum leverage. Comprehensive data collection and analysis also allow companies to recognize similar, yet slightly different, goods or services that might be standardized and aggregated to aid in leveraging.

Spend standardization and aggregation can result in a significant savings for a corporation. Therefore, developing data-gathering and analysis tools has been the foundation for many companies' indirect spend management programs.

Delta Airlines ("E-sourcing's Next Wave," *InformationWeek,* March 18, 2002) is one of many companies where data collection and analysis have been successful. Previously, the company's hubs had acted, in many ways, like independent business units, contracting for their own services and supplies. Employees in each SBU throughout the corporation were making deals without letting any other SBU know what those deals were. Delta finally installed a software package that revealed many areas where Delta could use its buying power to leverage discounts. Subsequently, Delta arranged contracts that saved the company millions. In just one three-month period, this contracting saved Delta $11 million on hotel rooms alone.

Cadence Design Systems also recognized the need for good data. Cadence had an ERP system in place, but the system was unable to present the information in such a way that purchasing could understand the nuances of the indirect spend. Management therefore decided to install a software package that automated the information extraction from the ERP into a separate analysis program. As a result, Cadence recognized several opportunities for negotiating larger discounts and curtailing some of its maverick spend. One executive claimed that they "achieved ROI in a matter of weeks and have already saved millions of dollars through intelligence provided" by this implementation.

Restructuring to establish accountability:

Establishing supply management structure and setting up accountability for indirect purchases are closely connected with data collection and consolidation. By gaining a clear understanding of who is spending what, where, and when, procurement managers can install procedures and/or safeguards that deter and control maverick spend. At that point, the delegation of responsibility for cost saving is critical. Such delegation includes setting up a chain of command that can respond with appropriate authority when demanding that protocol be followed. Case One details the design of a center-led indirect purchasing organization. With the flexibility to allow different regions to make localized decisions, this structure appears to be a good fit with the indirect sourcing needs of most large organizations.

By gaining a clear understanding of who is spending what, where, and when, procurement managers can install procedures and/or safeguards that deter and control maverick spend.

The Bayer Corporation ("'Money Rooms' Attack Bayer's Indirect Spend," *Purchasing,* November 1, 2001) provides another example of how a company can restructure its processes and responsibilities to manage indirect spend in a non-centralized structure. In tackling its indirect spend concerns, Bayer initiated a program it called the "Money Room." This program established "money rooms" in plants or administration units that act as control centers for the purchasing department. Indirect spend is typically mapped out into 20 to 25 areas (columns) and are linked to days of the month (rows). Each day all requests for materials are sent to this room, where they are charted. At a given time (which varies according to the needs of the SBU) control personnel meet to discuss that day's requisitions. If the requisitions meet that day's target spend and no foreseeable savings can be made, the orders are placed. If the day's requisition exceeds the target, the control personnel are responsible for finding ways of reducing or eliminating the projected spend. This can be done through consolidating SKUs for more leverage, delaying purchases, or by whatever means that the purchasing department seems reasonable. A control person is designated to manage this process and take responsibility for his or her SBU. Control persons are also expected to bring costs down to 80 percent of the historical figures. Finally, the control persons are rotated every three to four months to bring fresh ideas to the program. Bayer reports that this program saved 46 percent at one location.

Automating the requisition/purchasing process:
Companies have automated the purchasing process with electronic requisitioning, routing, approval, and purchase order/release creation. Such automation also facilitates receiving by automatically checking receipts against the invoice and purchase order. Finally, once the supply or service is complete, the automation can also ensure that payment is made. All of this saves time and money. As one executive from Miller Brewing points out, "This allows procurement managers more time to focus on the strategic areas of buying rather than having to worry about the mundane tasks associated with the various buying procedures."

By limiting requisitioners to the catalogs of goods and services already under contract from selected suppliers, volume commitments can be achieved and maverick spending reduced.

Standardization:
Coupling automated purchasing systems with e-catalogs can support standardization and aggregation of indirect spend. By limiting requisitioners to the catalogs of goods and services already under contract from selected suppliers, volume commitments can be achieved and maverick spending reduced. Some companies have gone so far as to insist that every indirect goods purchase made off-catalog must be submitted to an executive for approval. Case Two provides valuable insight into implementing and using automated purchasing systems.

EXTERNAL METHODS Successful external methods for managing and reducing indirect spend include reverse auctions, consortiums, and outsourcing.

Reverse auctions:
The popularity of reverse auctions continues to grow in scope and impact in the indirect buying arena (projected to increase 10 to 15 percent a year). Among the many reasons for this is that reverse auctions allow buyers and suppliers to economically communicate in real time, worldwide, via the Internet. Buyers are seeing substantial price reductions from reverse auctions. Some indicate they are seeing an average price savings of 10 to 20 percent. Although some question the sustainability of such savings, reverse auctions continues to have a significant impact for many companies. In addition, reverse auctions also has the potential to reduce the sourcing cycle-time by as much as 40 percent (*The Role of Reverse Auctions in Strategic Sourcing,* CAPS Research, 2003).

Consortiums:
One of the growing trends for improving buyers' leverage is the use of consortiums. Consortiums allow buyers from various businesses the opportunity to pool their buying power to reduce prices. Some companies, such as Raytheon, have been so successful at building and managing consortia that they can generate revenue by charging smaller businesses a service fee for using their consortiums ("Linking Supply Chains Saves Raytheon $400 million," *Purchasing,* August 2001).

Though the use of consortiums is growing, there can be problems with consortium management. Often one of the most challenging problems is getting the individual members to agree on exactly what is to be collectively purchased. Therefore, it is not uncommon for negotiations to be lengthy and intense, sometimes resulting in the decision to end the consortium altogether. Because of this and other problems, consortiums are often run by an independent third party. In this arrangement the buyers supply the third-party management team with specifications for the products they require. Consortium leaders then return with a product list that they feel best matches the needs of all the participants ("Consortium Procurement—A Look Inside," *Inside Supply Management®*, July 2002).

Purchasing outsourcing:

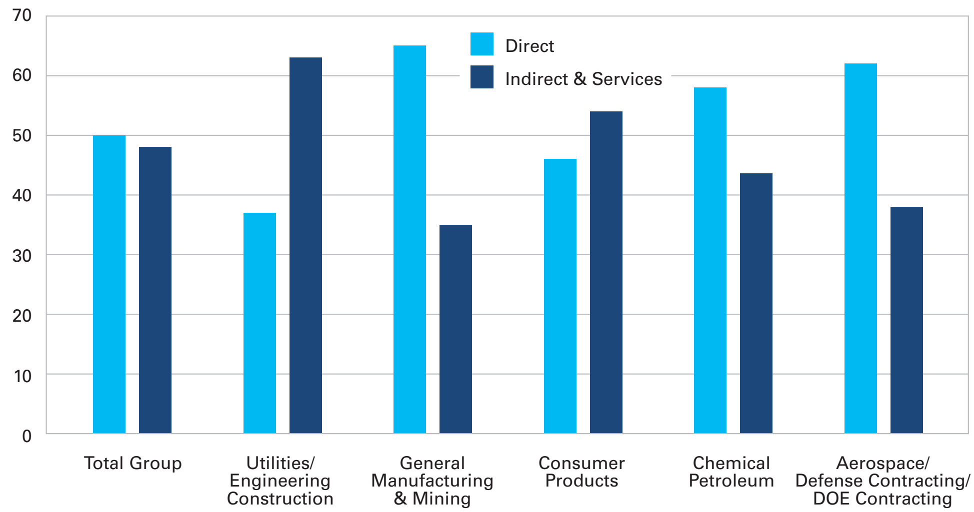
Finally, some companies have outsourced their indirect spend altogether. Harley-Davidson (H-D) provides an example of this ("Harley-Davidson Looks to Suppliers for Cost Savings," *Purchasing,* April 2000). H-D managers wanted to better manage indirect spend, but instead of ramping up their procurement department, they decided to outsource all of their indirect purchases to three reliable suppliers. In order to do this, H-D procurement went through a lengthy search for those outstanding suppliers whom they thought could handle this responsibility. They selected four suppliers (three of which agreed to the deal). These three suppliers then became responsible for making sure that all H-D indirect purchasing needs were met. They could either provide the needed supplies/services through their own company or buy from another company, as long as the supplies and services were available when needed.

The average indirect spend for a *Fortune* 500-size company, excluding service companies, is 50 percent of the total spend.

This program saved the company $4 million in the first year of implementation. H-D management expects this program to save $51.8 million over five years. (Case Four provides an in-depth discussion of another outsourcing example.)

SIZE AND NATURE OF INDIRECT SPEND CAPS Research has done extensive benchmarking defining the size of indirect spend within and across industries. The average indirect spend for a *Fortune* 500-size company, excluding service companies, is 50 percent of the total spend. The percentage of indirect spend varies by industry, from a low of 35 percent to a high of 60 percent (see Figure 1).

FIGURE 1 BREAKDOWN OF SPEND BY INDUSTRY

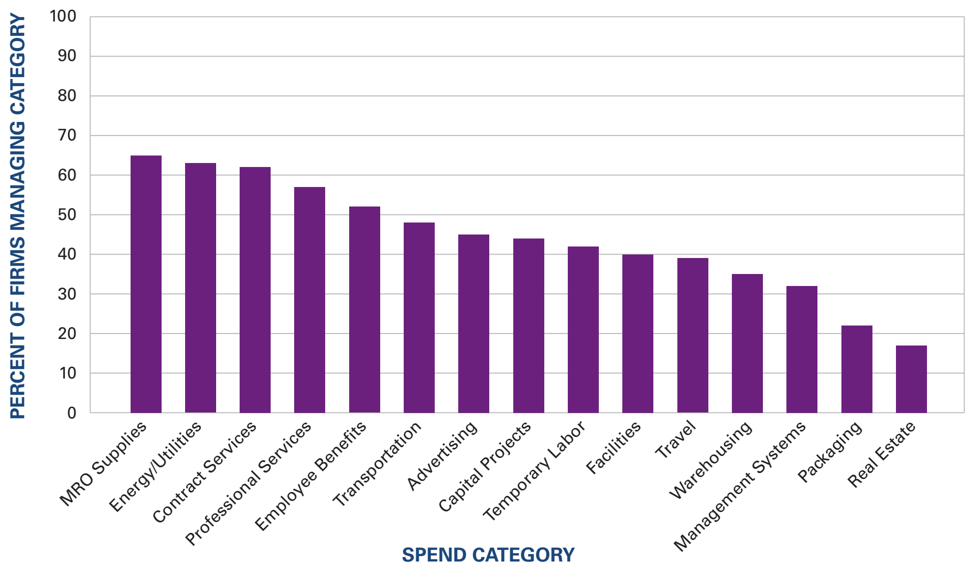


As companies continue to outsource non-core capabilities and bundle services with their products, the delineation between direct and indirect spend is becoming blurred.

As companies continue to outsource non-core capabilities and bundle services with their products, the delineation between direct and indirect spend is becoming blurred. For example, if a computer manufacturer also offers consulting services, should consultant travel be classified as a direct or an indirect spend item? Controlling spend that is difficult to identify, quantify, and assign to particular users is challenging for all companies.

CAPS Research studies indicate that the percentage of firms for which indirect spend is managed by purchasing/supply varies by category from 15 percent for real estate to 65 percent for MRO (see Figure 2). Overall approximately 75 percent of indirect spend is managed by purchasing/supply.

FIGURE 2 PURCHASING/SUPPLY CONTROL OF INDIRECT SPEND CATEGORIES



However, even though a category of spend may be managed by purchasing/supply, it is likely that much of it is not *fully* under control. This lack of control results from:

1. the relatively high amount of maverick spend that occurs in most companies, and
2. the difficulty in identifying indirect spend.

Furthermore, there is strong evidence that the percentage of indirect spend items that are *strategically* managed is quite low.

INDIRECT SPEND ISSUES Previous research has identified the following issues that are closely associated with indirect spend:

- E-tools
- Buying services
- Organizational form
- Reverse auctions
- Spend analysis
- Tracking and capturing savings
- Commodity strategies
- Spending
  - Off contract
- Not with preferred suppliers
  - Cataloging

At a recent Partnership Research Conference, four companies presented processes, tools, and techniques that they have used to address these issues. Each company had a novel approach for addressing one or more of the problems associated with indirect spend. When these four cases are combined, they present a comprehensive picture of the strategies and tactics that can be employed to reduce the cost of indirect goods and services.

Several companies stated that they forced 5 to 10 percent budget reductions on all indirect items.

ENABLING TACTICS/STRATEGIES Key enabling tactics that were identified in the case studies and in the group discussions are summarized below. The cases that follow provide greater detail and place the tactics in context of the firm that engaged them.

1. Zero-Based Budgeting

   Tracking and capturing the savings achieved by purchasing/supply is very difficult to accomplish in most organizations. One method to address this issue is *zero-based budgeting*. This method forces SBUs to start with the same budget they had in the previous planning cycle. Once the budget is prepared, purchasing/supply examines the spend categories and looks for cost-saving opportunities. If opportunities are found and lower-cost contracts signed, the SBU must "write a check" to the CFO for the amount of the savings.

2. Pre-Budget Savings

   Another approach to capturing negotiated savings is forced budget reductions. Several companies stated that they forced 5 to 10 percent budget reductions on all indirect items. SBUs then had the option of:
   - Negotiating price reductions on current volumes
   - Aggregating spend within or across SBUs and using the resulting leverage to gain price concessions
   - decreasing demand
   - Using a combination of the above approaches

   In general, most companies try to cut back on demand. Though this may be a desirable strategy for certain items, it could have a negative long-term effect. For example, if purchasing cuts back on supplier visits, supplier management efforts may be hindered.

3. Organizational Structure

   One of the most important decisions purchasing/supply can make regarding indirect spend is the structure of its indirect purchasing/supply group. The debate about centralized, decentralized, and center-led organizations is one of the oldest in purchasing/supply. Case One details the design of a center-led organization. With the flexibility to allow different regions to make localized decisions, this structure appears to be a good fit with the indirect sourcing needs of most large organizations.

4. Integrating Accounts Payable into Purchasing/Supply

Several companies had integrated accounts payable into the purchasing/supply organization. This change addressed one of the more pressing problems with indirect spend, namely contract compliance. This arrangement gave purchasing/supply the power *not to pay* for indirect items that were bought off contract. To have the bill paid, the SBU is forced to speak to the CFO, an embarrassing and rarely repeated process.

"Power spenders" are those individuals in the corporation that control large amounts of indirect spend. These individuals typically have positions of great authority within the corporation or SBU.

5. Power Spenders

"Power spenders" are those individuals in the corporation that control large amounts of indirect spend. These individuals typically have positions of great authority within the corporation or SBU. Due to their authority and the volume of the spend they control, purchasing/supply often has a hard time getting power spenders to comply with purchasing/supply policies. Several companies reported that properly training power users is key to controlling their spend. This training includes information on general strategic sourcing strategies and specific information on the strategies and tools employed for indirect spend. Once trained, the enlightened power spenders are usually willing to comply with contracts and play a proper role in reducing indirect spend. In fact, power spenders often became great champions of strategic sourcing.

Power spenders typically are allowed to find new suppliers and negotiate new deals as they see fit. However, they are also responsible for finding and leveraging sourcing opportunities for the corporation as a whole. Though this policy is somewhat difficult to manage, training power spenders can yield significant savings without incurring the political price associated with explicitly cutting or controlling their budgets.

6. Supplier Managed E-Catalogs

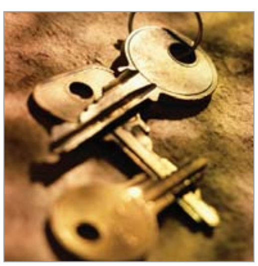
E-catalogs, coupled with automated requisitioning and purchasing systems, help companies ensure compliance to contracts. However, most of the participants stated that creating and maintaining inhouse e-catalogs is extremely costly and difficult. In general, there was a consensus that, if possible, the company should rely on supplier-managed e-catalogs.

7. Commodity Coding for Indirect Spend

Most of the group agreed that assigning and maintaining commodity codes for indirect goods and services is extremely difficult. Indirect goods can often be logically coded in different ways (e.g., batteries could be coded as electrical devices or energy devices). This leads to inconsistent coding or no coding ("other" and "miscellaneous" are the two most often used codes).

Supplier coding is also a challenge. Large suppliers of multiple indirect items often have multiple shipping and billing addresses, resulting in multiple codes being assigned to the same supplier. This masks the size of the total spend with the supplier and hinders the buying company from fully leveraging its spend with the supplier.

To help counter these problems, the group recommended limiting commodity codes to a few levels. This makes it easier for the end user to properly identify commodities and to reduce the search time for the "perfect" code.



8. One Commodity Team Assigned to Large Suppliers
   Many challenges can occur when purchasing from large suppliers with a diverse product offering. These challenges include commodity coding and standardizing prices, terms, and conditions. One interesting solution is to assign a specific commodity team to work with each large supplier. When another buying team is considering using this supplier, a team member assigned to this supplier is brought in to assure that existing contracts with standardized prices, terms, and conditions are used by the buying team. This approach helps the buying company counter the common "divide-and-conquer" strategy used by large suppliers.

9. Outsourcing Indirect Sourcing
   Although outsourcing part of purchasing/supply can be controversial, it can bring big benefits. One of the presenting companies (see Case Four) decided to outsource the sourcing of its non-strategic indirect spend. This bold move had a number of benefits. The first was an up-to-date e-catalog that was implemented in a matter of months. The second was ironclad control of indirect spend with real-time data. The third was a great reduction in the cost of indirect goods and services. And lastly, the company was able to reduce its headcount. Several participants expressed some concern about having a third party manage 25 percent of a company's total cost of goods sold. One particular concern was that the stellar service level provided by the outsourcing partner might diminish if the partner took on significant new customers.

CASE REPORTS

Four cases were presented that highlight some important methods and management techniques for managing indirect spend.

The first case stresses the importance of having a purchasing/supply organization designed around the acquisition of indirect goods and services. With a focused organization and the backing of upper management, the strategic goals of the company can be matched to the sourcing methods employed by the indirect sourcing group.

The second case demonstrates the important role that purchasing automation/information systems can play in managing indirect spend. Once installed, these systems allow a firm to acquire spend data and facilitate contract compliance. However, this case also brings to light problems associated with implementing IT systems across multiple firms in multicultural environments.

Purchasing/supply is seen as a growth engine for the company and is expected to lead cost-reduction efforts to generate cash for product development, acquisitions, advertising, and merchandising.

The third case illustrates an effective method for buying complex services. Advertising, legal services, IT services, and management consulting are all labor-intensive services, the results of which are difficult to quantify. However, by understanding the cost structures of the industry and of the company performing the service, the buying firm can greatly improve its position. With detailed "should-cost" information and contracts that favor open disclosure, the buying company can identify those firms with the best service and cost.

Lastly, the fourth case shows that if dramatic results are needed quickly, there are third parties that are capable of helping a company greatly reduce its indirect spend. Business Process Outsourcing partners are capable of installing fully functional e-catalogs in a matter of months. Further, the new catalog and spend information can be used to strategically manage indirect spend, reducing costs quickly. Also, the company's spend can be aggregated with that of other companies, creating greater leverage and savings than the company could achieve on its own. However, this case also highlights the risks associated with turning part of the purchasing/supply organization over to a third party.

CASE ONE
CREATING AN INDIRECT PURCHASING/SUPPLY ORGANIZATION

Case One is a large consumer and industrial goods provider with 2002 sales of approximately $16 billion worldwide, more than half of which is derived from international operations, and earnings of approximately $2 billion. The company has approximately 70,000 employees worldwide and produces more than 80,000 products.

With $3.8 billion in indirect spend, purchasing/supply is challenged to effectively leverage this spend across geographically and functionally disperse operations to help the corporation achieve its overall goals. Purchasing/supply is seen as a growth engine for the company and is expected to lead cost-reduction efforts to generate cash for product development, acquisitions, advertising, and merchandising.

The company's approach to this challenge includes revamping its organizational structure and elevating the role of purchasing/supply. The new corporate structure has the following functions:

- Business Development and Corporate Services
- Engineering, Manufacturing, and Logistics
- Finance
- Legal Affairs and General Counsel
- Research and Development
- Human Resources
- Marketing

PURCHASING/SUPPLY ORGANIZATION Purchasing/supply resides within the Engineering, Manufacturing, and Logistics group and is divided into six groups as shown in Figure 3. Indirect purchasing/supply responsibility resides at the director level and is organized as shown in Figure 4.

FIGURE 3 SOURCING ORGANIZATION

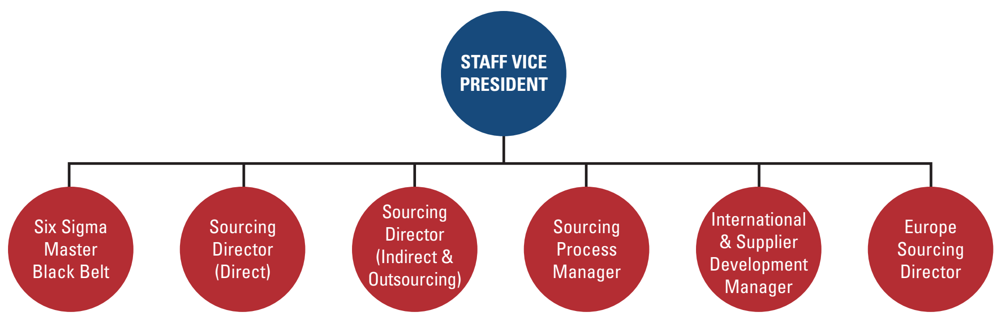
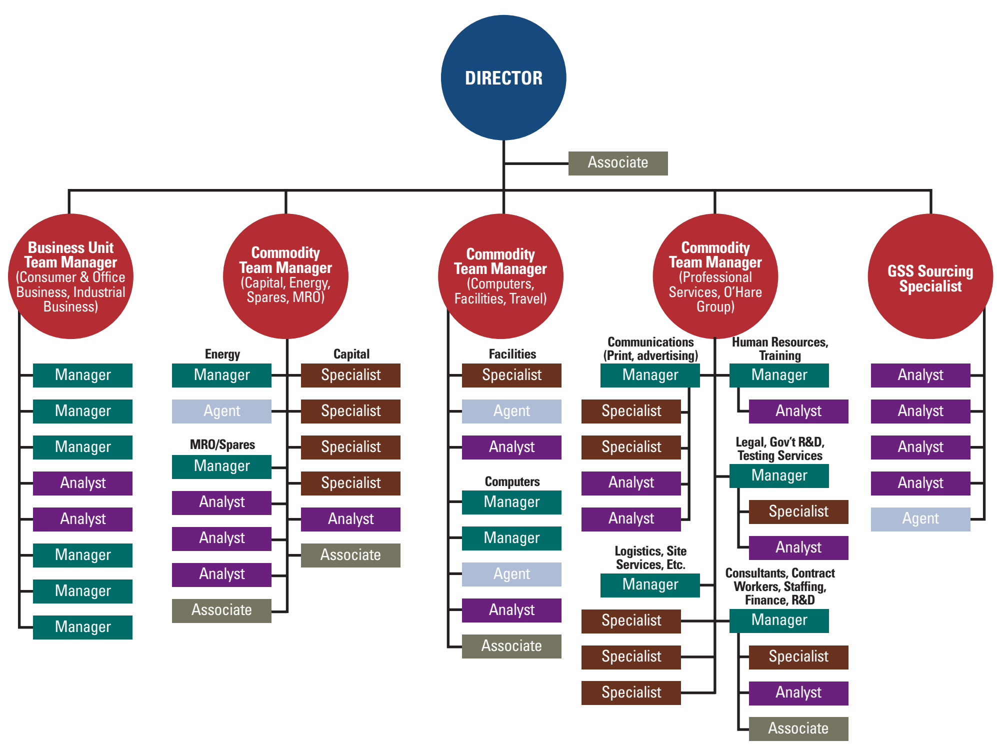


FIGURE 4 INDIRECT PURCHASING/SUPPLY GROUP



This group is responsible for the $3.8 billion in indirect spend. Indirect spend encompasses a wide variety of categories. Figure 5 provides a breakdown of the company's indirect spend.

The company has integrated its global needs within the structure of its global commodity teams, an especially interesting approach.

FIGURE 5 BREAKDOWN OF INDIRECT SPEND: GLOBAL INDIRECT SPEND = $3.8 BILLION

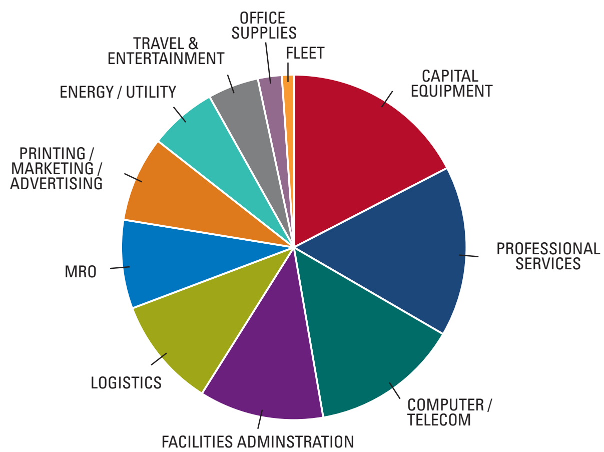
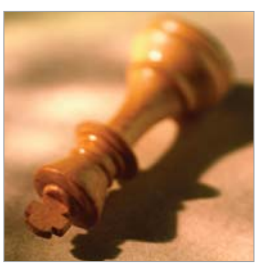


Figure 4 indicates that the indirect purchasing/supply group is divided into five teams. The first team supports specific business units. Three teams are responsible for specific commodities. The fifth team is responsible for global purchasing/supply. The company has integrated its global needs within the structure of its global commodity teams, an especially interesting approach. The remainder of this case discussion focuses on the commodity teams.

GLOBAL COMMODITY TEAMS The company has 60 global commodity teams that cover 14 major commodities, including direct and indirect goods and services. These teams, though geographically disperse, interact frequently in bi-weekly meetings designed to increase knowledge and share information. The teams also file sourcing progress reports monthly to senior purchasing/supply managers.

There are three distinct roles within the team. The first is the *Commodity Team Leader*, whose responsibilities include:

1. Achieve results through:
   a. Strategy development
   b. Working knowledge of tactics and tools
   c. Supplier selection



   d. Contract negotiations
   e. Strategic supplier management
   f. Global targeted results
2. Work with business units and staff groups to develop and implement global commodity strategies to achieve deflationary pricing.
3. Lead, influence, interface, and represent the global commodity team to senior management, clients, suppliers, and customers.
4. Develop and implement global sub-commodity teams and assure strong global integration.
5. Assure effective utilization of the Global Strategic Sourcing (GSS) process.
6. Lead supplier development and supplier qualifications for "corporate" suppliers and review all supplier Six Sigma initiatives.
7. Act as area coordinator for home location (share purchasing practice with sales group to give them a heads up when policies change).

The second role is *Area Commodity Coordinators* who are responsible for the geographic regions of North America, Europe, Latin America, and Asia. The Area Commodity Coordinators oversee IT, logistics, MRO/OEM and supplies, travel, and professional services purchases within each of their assigned regions. Each Area Commodity Coordinator reports to a lead in North America and has the following responsibilities:

1. Represent his/her area on the Global Commodity Management Team on the following topics:
   a. Strategy development
   b. Tactics and tools
   c. Supplier selection
   d. Contract negotiations
   e. Strategic supplier management
   f. Area targeted results
2. Be knowledgeable of commodity, supply base, and company's requirements in the purchasing area.
3. Lead the implementation of global purchasing/supply strategy in his/her area and provide leadership for local purchasing/supply people to ensure the desired results for assigned commodity.
4. Communicate commodity needs to sourcing engineers in cost-competitive countries.

The third role is *Sourcing Engineers* in cost-competitive countries. The company has launched an initiative to expand purchasing/supply to low-cost regions, which is expected to provide a 15 percent cost savings. In order to accomplish these goals, the Sourcing Engineers are responsible for:

1. Support of the Global Commodity Management Teams (direct, indirect, and outsourced manufacturing)
2. Identification of lower-cost suppliers
3. Qualification of lower-cost suppliers
4. Management of new suppliers to achieve cost-reduction objectives

FEET ON THE STREET Sourcing Engineers employed in low-cost regions are members of a special group called "Feet on the Street." This group includes all of the company's employees stationed in cost-competitive countries. The "Feet on the Street" group performs reverse marketing, i.e., selling the company to prospective suppliers, for the Global Commodity Teams. Because they are in-country, this group is able to identify low-cost suppliers earlier than the company's competitors. In addition, because they are company employees, the company does not have to worry about their allegiance. Although agents cost less than company employees, the company is concerned that an agent's allegiance may be split between the company and in-country suppliers.

Sourcing deputies are full-time employees from other functional areas that have dual responsibility for their functional areas and purchasing/supply.

SOURCING DEPUTIES Another innovative approach is the use of *Sourcing Deputies*. Sourcing deputies are full-time employees from other functional areas that have dual responsibility for their functional areas and purchasing/supply. Sourcing Deputies receive specialized training in strategic purchasing/supply. Only after a person has completed training and passed a comprehensive test can they purchase goods and services for their functional area or SBU. Currently, the training classes are full.

Sourcing Deputies are expected to retain their functional expertise as well as look for cost-saving opportunities within their functional area's purchases. A Sourcing Deputy moves from a single career track to a dual track and his/her Balanced Score Card contains metrics from the functional area as well as purchasing/supply. Sourcing Deputies have proven to be extremely helpful in extending purchasing/supply's influence throughout the company.

In addition to the above organizational structure, several important enablers have helped the purchasing/supply organization achieve excellence. The first of these is the steadfast support of upper management, which has endorsed a companywide purchasing/supply policy. This policy states that the Sourcing Operations Group (the official title of the purchasing/supply group) will be responsible for sourcing all goods and services. This policy helps to drive spend aggregation and contract compliance.

A second important enabler is a clear process for sourcing indirect spend. The purchasing/supply group has created a dual-path framework with one path for routine purchases and a second for new purchases.

INDIRECT SOURCING FRAMEWORK Routine purchases meet the following conditions:

1. Contract in place
2. Low value/low risk:
   a. Purchase is forecasted to be less than $100,000.
   b. Purchase does not pose a business risk, e.g., intellectual property, hazardous material, etc.
   c. No leverage opportunities exist across multiple functions.

For these purchases, a purchase order, e-catalog, procurement card, or release to a contracted supplier can be used. Eighty percent of all purchases fall into this category.

For the remaining 20 percent, the following process is followed:

1. Identify the sourcing need and analyze the budget and supply plan.
2. Conduct a make-or-buy analysis.
3. For buy decisions:
   a. Create preliminary authorization and notification.
   b. Create project team leader.
   c. Develop sourcing strategy and identify potential suppliers.
   d. Prepare negotiations strategy and objectives; develop and send RFQ/RFP.
   e. Analyze quotes and proposals and select suppliers.
   f. Negotiate and finalize contracts.
   g. Obtain company approval of contract.
   h. Maintain contract and manage supplier improvement.

SUMMARY With a comprehensive vision of the best organizational structure to achieve its goals, upper management support, and innovative techniques and processes, this company's purchasing/supply organization continues to drive cost reductions. As senior management continues to invest these savings into R&D, acquisitions, and marketing, purchasing/supply will remain one of the major drivers of long-term shareholder value.

CASE TWO
E-PROCUREMENT FOR INDIRECT SPEND

COMPANY BACKGROUND Case Two features a global company, which, in 2002, had annual revenues of €6 billion with 25,000 employees and 114 production units operating in eight strategic markets:

- Pharmaceuticals
- Consumer Care
- Industrial Care
- Electronics
- Agrochemicals
- Food
- Automotive
- Fibers

This company recently was spun off from its long-time parent. In order to develop its own culture and achieve shareholder return on investment, it embarked on a global "best-in-class" change initiative. These projects were designed to enhance the performance of the company by improving the efficiency of manufacturing, purchasing, sales, and innovation.

Included in the purchasing initiative is an enterprise business purchasing/supply process for indirect spend. The initiative's mission for improving indirect spend performance is: "To develop and implement an intranet-based, global electronic platform enabling 'Best-in-Class' Procurement Practices and Cost."

THE PROCUREMENT INITIATIVE The company recently transformed its purchasing/supply organization from one that was highly decentralized to one that is centered on three geographical regions. A large portion of the regional efforts involved decreasing indirect spend through the following initiatives:

- Purchasing/supply process optimization with electronic catalogs
- Measured results:
  - Annual savings goal of 5 percent of spend
  - Reduce purchasing/supply complexity
- Common global technology
- Stronger supplier relationships

Initial investigations revealed that a large proportion of the company's indirect spend could be sourced electronically. They classified spends as e-procurable and e-catalogable.

In Europe, they identified:

- €550 million as e-procurable, of which €260 million was e-catalogable

In North America, they identified:

- $170 million as e-procurable, of which $100 million was e-catalogable

Purchasing/supply's senior management decided that installing e-catalogs offered the greatest immediate benefits to their organization. They identified the following product domains that were considered e-catalog compliant:

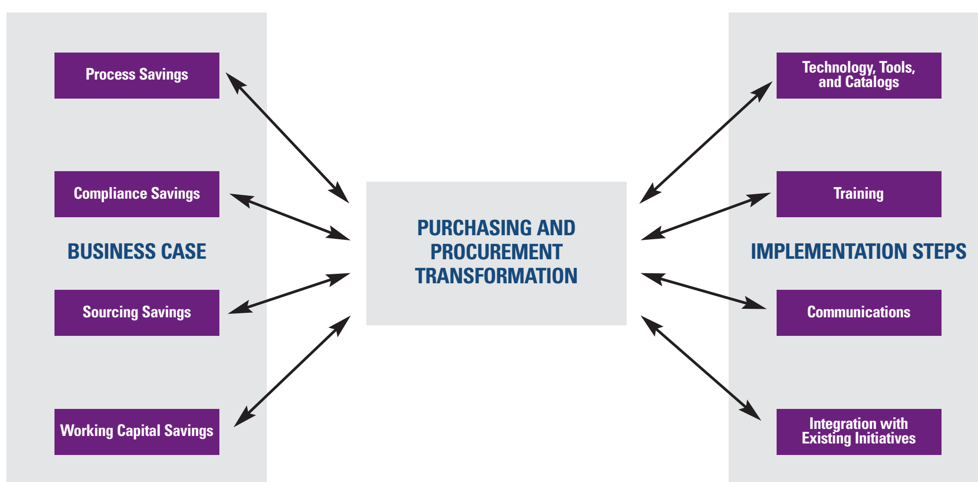
- General expenses
- Packaging
- Transportation
- Industrial supplies
- Raw materials purchased from distributors
- Industrial services

Integrating the different suppliers' catalogs into this company's internal catalog has been a major challenge. Currently, only 80 of 175 e-catalogable suppliers are in their internal e-catalog. Although suppliers are rapidly being added, the company admits that it was unaware of the challenges in creating and managing an e-catalog.

Aside from these implementation challenges, the company believes the use of an e-catalog still promises many benefits. Examples are the ease with which the e-catalog system tracks transactions and total dollars, and the ease with which experienced and frequent users of the system can perform successful searches. However, the system is not entirely user friendly, as the user needs a fairly accurate description of the product or service for successful e-catalog inquiries or searches. Since they did not build their catalog query protocol on "shop terminology," searches are more difficult for occasional users. Not finding what they need may cause them to assume that the product or service is not in the catalog and, as a result, they fill their needs outside of existing contracts, which actually can increase maverick spending.

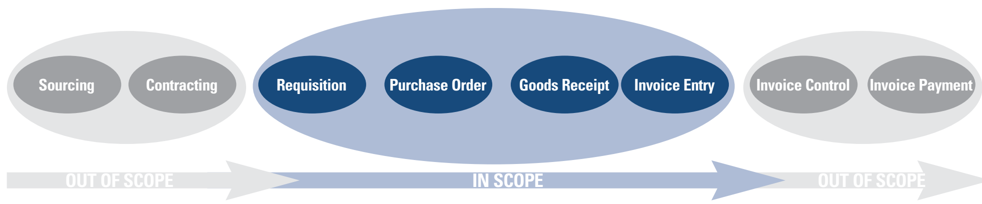
When this company first envisioned an e-enabled sourcing group, it built its business case around the implementation steps necessary to create a complete purchasing/supply transformation (see Figure 6).

FIGURE 6 PURCHASING AND PROCUREMENT TRANSFORMATION DRIVERS



SYSTEM'S BUSINESS CASE Many companies take a more holistic approach to e-purchasing/supply, which includes the entire full range of purchasing functions. However, this company limited its initiative's scope to include requisition, purchase order, order receipt and invoice entry. Figure 7 clearly shows the initiative's scope.

FIGURE 7 INITIATIVE'S E-PURCHASING/SUPPLY SCOPE



The system business case targeted four cost-savings opportunities:

- Sourcing
- Compliance
- Working capital
- Process improvement

Figure 8 shows the expected savings associated with each aspect of the business case.

FIGURE 8 EXPECTED SAVINGS

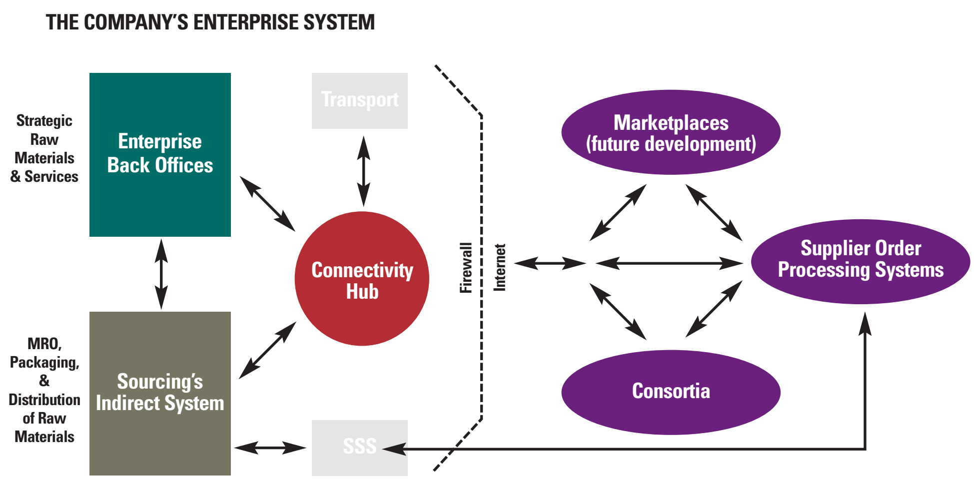
OPPORTUNITY	SAVINGS
Sourcing	40%
Compliance	30%
Working Capital	20%
Process Improvement	10%

The savings from each opportunity are due to the following actions:

- Standardization—reduces choice, reduces inventory, and increases inventory sharing.
- Supplier rationalization—the catalog forces buys through a few selected sources.
- Aggregation of spend to increase purchase leverage
  - Global
  - National
  - Regional
  - Platform
- Compliance
  - Use preferred supplier
- Catalog compliance—without choice, buyers are forced to spend with approved suppliers.
- Working capital—Inventory reduction
- Process improvement
  - Electronic approval process (The company has been using an electronic approval process for five years.)

One of the key components of the company's e-sourcing systems is its high level of connectivity with suppliers. The company achieved this through globally deploying SAP's buyer module as part of its SAP enterprise system. Figure 9 depicts the company's supplier connectivity plan.

FIGURE 9 SUPPLIER ELECTRONIC CONNECTIVITY



- The company can connect with suppliers by one of several options
- Best suppliers will use XML, preferably xCBL or CIDX
- EDI not shown

IMPLEMENTATION Implementation was scheduled for 44 locations, with a focus on the 15 locations that comprised 80 percent of European spend. Europe currently has 1,700 system users, far short of the company's initial hopes. Four issues delayed the European implementation:

1. European culture (multiple languages and countries) was not conducive to preferred suppliers' adoption.
2. Half of SAP buyers' orders never were sent to the suppliers because of technology problems, with an effective loss of 50 percent of POs generated.
3. Multiple back office systems slowed implementation.
4. European users and suppliers did not possess the information systems, training, or skills to match their U.S. counterparts.

The SAP connectivity issue took over a year to fix, resulting in a loss of confidence in the system. This delay, combined with the cultural issues, caused the company to place further European implementation on hold and focus on North America.

The North American implementation covers 25 locations with over 500 users and is being accomplished with greater speed because:

- The users have greater confidence in the system due to increased reliability.
- Supplier rationalization has gained greater acceptance in North America when compared to Europe where suppliers are considered a more integral part of the company.

The presenter also felt that the e-catalog's greatest impact would be on compliance, i.e., reduction/elimination of maverick buying.

The company has revised its European implementation using the lessons learned in America and will begin a "re-implementation" shortly. However, implementation in South America (12 locations with 1,500 users) and in Asia (15 locations with 500 users) are permanently on hold.

RESULTS The company did not quantify or elaborate on the results during its presentation. However, the executives did indicate that results were far less than expected and that their ROI objective had not yet been achieved, even in North America. However, the presenter (also the project leader) felt that positive results would occur as more locations implemented the e-catalogs. The presenter also felt that the e-catalog's greatest impact would be on compliance, i.e., reduction/elimination of maverick buying. Once compliance was assured, the benefits of supplier rationalization and leveraging could be realized. Finally, once the e-catalogs are in place, the presenter felt that the sourcing group could focus more on strategic sourcing issues instead of execution.

SUCCESS FACTORS Two of the more important success factors identified by this case are:

- Work with suppliers that are willing to fully embrace the new technology.
- Ensure that the technology is fully tested and working correctly prior to implementation.
- Establish a critical mass of cataloged goods and services prior to implementation.

LESSON LEARNED

- Not all suppliers are equal in technology skills.
- The company's e-skills were less than anticipated. This lack of skills affected the ability to implement the plan on time and on budget. Even the North American users, with more electronic purchasing exposure than their European counterparts, were not adequately prepared.
- Response time is only as good as available bandwidth. While suppliers may be capable, if the IT infrastructure is not available, delays due to bandwidth will discourage use.
- The training plan was insufficient. Implementation was delayed or slowed until a robust training schedule was developed.

- If a user knows how to search the catalog, the response time increases by 50 percent. Therefore, training and smart search engines are a must.
- Preferred suppliers are often difficult to implement.
- "[Maybe] we bought a Cadillac, when a Chevrolet would work." The presenter felt that the company had paid too much for a system that was designed to address problems far outside the scope of their project. It is likely that a smaller system that required less training and less connectivity may have done the job and been less difficult to implement.

Further, attempting to internally manage suppliers' catalogs is inherently more difficult than using a third party or the suppliers' own catalogs.

In summary, implementation of an e-catalog is a challenging venture. Although this tool promises to better manage indirect spend and aid in compliance, the costs (time, budget, and effort) are high. Further, attempting to internally manage suppliers' catalogs is inherently more difficult than using a third party or the suppliers' own catalogs.

CASE THREE

MANAGING INDIRECT SPEND THROUGH ACTIVITY-BASED COSTING: THE CASE OF ADVERTISING This case involves a large pharmaceutical company and its quest to reduce its advertising costs, one of the largest of its indirect expenditures. The company has global revenues in excess of $14 billion; U.S. revenue is $3 billion. The company operates in 120 countries with 50,000 employees. Its products include consumer health care products, pharmaceuticals, and animal health products. However the company's major source of revenue is derived from pharmaceuticals. This business is very risky—only one of the roughly 7,000 drugs screened by the FDA is approved.

The industry focuses its research on finding the next blockbuster drug—a drug that will generate a billion dollars in sales. However, the costs associated with developing a new prescription drug have steadily increased over the past 20 years—rising from $180 million in 1980 to $801 million in 2002. The industry spends on average $30 billion in R&D, which is approximately 17 percent of revenue. In comparison, the computer industry spends 10.5 percent of revenue on R&D. The problem is that the productivity of R&D dollars has been diminishing. Over the past 20 years, R&D expenditures have increased dramatically, while the number of new drugs submitted for FDA approval has leveled off.

One of the fastest rising and most difficult expenditures to control is advertising. Advertising is a competitive priority for the pharmaceutical industry. A new drug launch is very important, as is maintaining market share as competitors enter the same space. In order to recoup the company's large investment, a new drug must make a significant initial impact on the market and then steadily increase its revenue.

Though advertising is extremely important to the Case Three company, it never had properly managed its advertising agencies. Because these agencies fell under the domain of marketing, they were chosen for their creativity, not necessarily price, TCO, or their marketing effectiveness. In addition, advertising budgets typically ran 60 percent to 100 percent over budget. Due to increasing competitive pressures and the past successes of its strategic sourcing initiative, upper management requested that the strategic sourcing group address total advertising agency costs and performance. The sourcing group was mandated to create methods to decrease advertising expenditures without lessening advertising effectiveness. However, the challenge is in managing a creative process that is typically viewed as a black box, i.e., a request for advertising services is given to an ad agency, and, presto, a campaign is created.

Due to increasing competitive pressures and the past successes of its strategic sourcing initiative, upper management requested that the strategic sourcing group address total advertising agency costs and performance.

To meet this challenge, the company's strategic sourcing group created a cross-functional team to address this problem. The first step of the team was to create a charter. The charter stated that the team would develop a mechanism(s) for cost control, performance monitoring, and communication to span the following areas:

- Contract terms
- Compensation
- Budget reconciliation
- Performance evaluation

Upper management reviewed and approved this charter, thus providing the team with an important mandate as it interacted with each SBU's marketing department. (This was the first time that anyone in the company looked at all advertising expenditure across the entire business.)

In order to address the challenges in the charter, the team first had to clearly identify the project's objectives. These objectives consisted of:

- Developing a consistent, equitable, and mutually beneficial advertising agency compensation model
- Identifying the tools needed to effectively manage the agencies

To meet these objectives, the sourcing team benchmarked with other firms and held in-depth interviews with agencies, consultants, and secondary sources (former agency employees) to determine best practices and agency internal costs. One of the more interesting tools they used were blind interviews. Ad agency employees were encouraged to speak freely about the qualities of a "good customer" without fear of retribution by the company.



Through these interviews and site visits, the sourcing team learned that ad agency billing was closer to an art than a science. Their research into the agencies' billing structures revealed the following:

1. The FTE hours the agency planned to bill exceeded the contracted FTE hours. (FTE is defined as a "full-time equivalent," or the total hours a person works in a year.)
   - Agency resources were utilized across multiple brands of the company and exceeded the contracted FTE allowance.
   - The team discovered that agencies were double billing across advertising projects.
2. The agencies' rate structures were unclear and misapplied.
   - Billing for administrative functions was to be included in overhead charges, yet appeared consistently as a line item on the bills to the company.
   - Flat fees were commonly used to hide rate increases, misallocated FTEs, and overhead padding.
3. Analysis of cost allocation multipliers revealed large and unexplained variances. (Multipliers are used to determine overhead, profit, and benefits.)
   - The team discovered a large variance in multipliers across agencies, with a range of 1.67 to 2.89.
   - There was no correlation between the multipliers and location or the current billing rate of agencies.

The general conclusion was that agencies were not managing their costs and were passing this mismanagement onto their customer.

The sourcing team realized that they needed a new way to compensate the advertising agencies. The new method needed to be:
1. flexible enough for each SBU's differing requirements;
2. based on cost-benefit tradeoffs between monitoring costs and allowing for agency creativity;
3. adjustable for market trends; and
4. structured to create incentives for the agencies to perform.

The team decided that a labor-based compensation model would fit all the above mentioned requirements. An example of this model is shown in Figure 10.

FIGURE 10 LABOR-COMPENSATION MODEL

"COMPOSITE PERSON" (I.E., BLENDED RATE)

STAFFING PLAN	HOURS	RATE	TOTAL
Account Management	3200	$300	$960,000
Creative	1000	$150	$150,000
Media	850	$90	$76,500
Research	500	$120	$60,000
Total	5550		$1,246,500
Blended Rate		$225	

Basis for Fee

The labor-based approach has the following characteristics:

- Functional rates are set at the agency level. Each functional group within an agency will ascribe to a pre-determined rate structure. That is, an account manager will be paid X, a research assistant will be paid Y, and a secretary will be paid Z.
- Determine blended agency function rates to each brand level (certain brands that require more strategic thinking will be paid more than strict execution accounts).
- Lock in the profit rate across agencies.
- Lock in multipliers by agency, allowing for talent caliber variability.
- Lock in function rates. (Note: The strategic sourcing team will monitor for market competitiveness.)
- Revisit blended brand rate annually, based on updated staffing plan.
- The blended rate multiplied by the estimated hours will equal the total agency fee (by brand).
- The total agency fee is not to exceed the contracted amount, unless there is a scope change. (This ensured that double billing will not occur on multiple brands.)

The sourcing team decided that the budget reconciliation process provided the best mechanism for controlling costs, contracts, and ad agencies.

Once the labor-based compensation plan was put in place, the team needed to find a method for administering the contracts, managing the agencies, and ensuring that their internal marketing departments managed their budgets. The sourcing team decided that the budget reconciliation process provided the best mechanism for controlling costs, contracts, and ad agencies. The team's new reconciliation process contains the following characteristics:

Frequency:

- Monthly reports—standardized for all brands
- Quarterly reconciliation—the same monthly report, but it must be reconciled against the budget

Enforce agency reconciliation process:

- Tied to evaluation
- Coupled with semiannual business review

Structure:

- Summary page highlights potential project issues
- Detailed backup (account services, out of pocket expenses, and measures of creativity)
- Freezes estimates and allows for a comparison of budget (estimates) to actual reconciled project lists
- Budget management accountability is shared by the client and the agency

The marketing departments and the agencies must keep the newly formed advertising commodity team updated on budget and project status. Figure 11 shows an example of a reconciliation spreadsheet that is used to track the project and the budget.

FIGURE 11 EXAMPLE OF A RECONCILIATION SPREADSHEET

RECONCILIATION REQUIREMENTS

Summary Page

PROJECT		BUDGET ($)	ACTUAL ($)	% UTILIZATION	% WORK REMAINING	STATUS	COMMENTS
Account Management	Fees	$350,000	$50,000	14.3%	80%	Ongoing	
	OOP	$50,000	$0	0%	0%		
Job 15489 (detail aid)	Fees	$40,000	$35,000	87.5%	25%	Ongoing	
	OOP	$5,000	$3,500	70%	0%		
Job 58974 (4 page insert)	Fees	$20,000	$0	0%	100%	Not Started	
	OOP	$0	$0	0%	NA		

Account Management Detail

NAME	% ALLOCATION	# HOURS	UTILIZATION (JAN)	UTILIZATION (FEB)	UTILIZATION (YTD)	COMMENTS
	50%	800	40 (5%)	80 (10%)	120 (15%)	
	100%	1600	240 (15%)	160 (10%)	400 (25%)	
	30%	480	0%	0%	0%	

Project Detail

PROJECT (HOURS)		ART	CAD	COPY	EDITORIAL	MEDICAL	TRAFFIC	STATUS	COMMENTS
Job 15489 (detail aid)	Budget	30	20	50	15	5	10	Ongoing	Change notice approved 1/24. Add art hours.
	Actual	29	10	5	2	5	0		
Job 58974 (4 page insert)	Budget	20	15	35	25	0	15	Not Started	
	Actual	0	0	0	0	0	0		

The sourcing team realized that advertising and marketing are strategically important to the company. Therefore, the team created three long lasting processes to ensure that advertising agencies continued to operate within budget and in the best interest of the company. These processes are strategic business review, training, and trend analysis.

Therefore, the team created three long lasting processes to ensure that advertising agencies continued to operate within budget and in the best interest of the company. These processes are strategic business review, training, and trend analysis.

The first, strategic business review, is designed to ensure that the advertising agencies' goals are aligned with the company's long-term interests. It involves strategic supplier selection and supplier management. The strategic selection process ensures that chosen agencies do not support competitors. It is important that information regarding forthcoming campaigns does not pass to competing pharmaceutical and healthcare companies.

The business review process also ensures that the supplier management strategy adheres to the following guidelines:

- Standardized approach
- Single voice—avoid a divide-and-conquer strategy often used by suppliers
- Collaboration with clear communication
- Retain tribal knowledge
- Tied to the end of contracts or the budget planning cycle
- Facilitated by the commodity team and the marketing group

The tentative agenda includes:

- Review evaluation results based on gap analysis (two-way)
- Prioritize company items/issues and define action plan
- Best practices sharing (two-way)
- Outline short- and long-term business direction
- Discuss points of intersection and areas for development or change
- Reconciliation (plan of action for overages, shortages)

To promote strategic sourcing of advertising throughout the company, the team created a training program with two courses: Agency 101—a baseline course used to develop a common language and Agency 201—enhanced agency management techniques. All marketing personnel involved with managing ad agencies were required to attend.

Lastly, the sourcing team realized that the previous problems with sourcing and managing advertising agency services were due to a lack of accurate and adequate information. To counter this problem the team created a trend database based on previous and current agency project analysis. The database tracks agency productivity, labor costs, and tangible costs (number of color prints, number of copies, etc.). This database allows all SBUs to share information and provides advertising sourcing teams knowledge to effectively choose suppliers, negotiate contracts, and monitor their agencies.

The results of this process have been impressive. For the first time, advertising agency expenditures have come in on budget. There has been a 60 percent reduction in over-runs and a 50 percent decrease in advertising expenditures. Agencies that perform poorly are readily identified and their disengagement is a clear process. The training has become so popular that many marketing personnel take it more than once to ensure that they have the most current tools to manage their agencies. In addition, due to the performance of the strategic sourcing on this project, it has been chartered to perform similar projects for other service-spend categories.

In summary, by using a process similar to activity-based costing principles and utilizing the skills of knowledgeable internal and external sources, the strategic sourcing team was able to de-mystify the internal workings of the advertising agencies.

In summary, by using a process similar to activity-based costing principles and utilizing the skills of knowledgeable internal and external sources, the strategic sourcing team was able to de-mystify the internal workings of the advertising agencies. The team created a formal process backed by a powerful database that will allow the company to better choose and monitor its agencies. These processes have created lasting cost savings and value for the company. Lastly, with upper management support, clear objectives, and a cross-functional team, strategic sourcing has improved its reputation within the company and been invited to extend its expertise into other indirect spend areas of the company.

CASE FOUR
OUTSOURCING INDIRECT SPEND

INDUSTRY BACKGROUND The industry to which this company belongs has rapidly transitioned from a highly regulated to a deregulated, highly competitive industry driven by rapid technology innovations and new products. In addition, the industry is plagued with overcapacity and declining demand in a period of economic retrenchment.

COMPANY SITUATION The company has recently transformed itself from a multi-business unit, multi-customer organization with $30 billion in revenues and more than 150,000 employees, to a smaller organization focused on global wireless and wire/line infrastructure with $12 billion in revenues and 40,000 employees. The cultural transformation, from a regulated industry to a smaller agile company, has presented unique sourcing opportunities. One of these opportunities is addressing the management of indirect spend.

In recent years, the purchasing/supply organization was faced with the challenges of severe downsizing and the requirement to deliver significant savings. Part of these savings was expected to come from eliminating maverick (off-contract) spend. The company estimated that 50 percent of indirect spend was “off contract.” Worse still, internal cycle times were unacceptable when compared to benchmarking data from other peer firms.

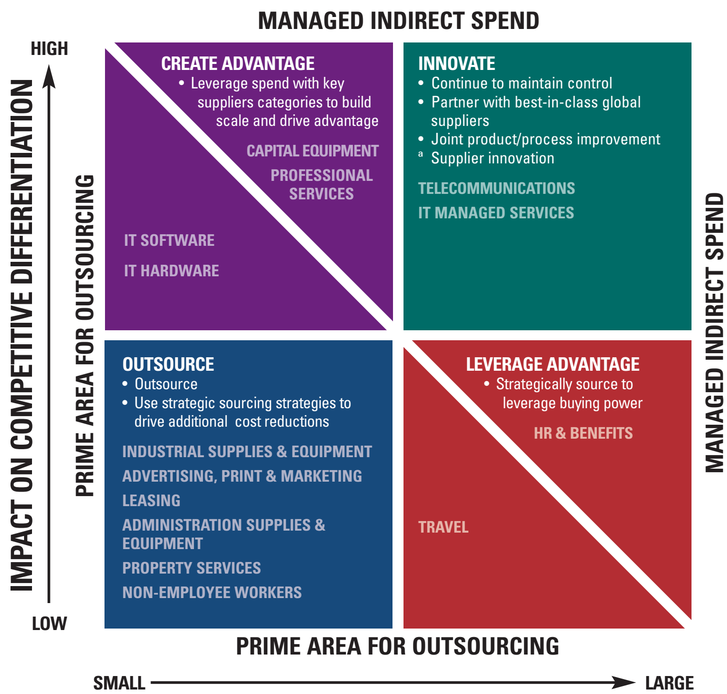
To help address these problems the purchasing/supply organization first developed a list of goals and reviewed methods to achieve them:

- Focus on core competencies.
- Reduce headcount.
- Standardize global processes and systems.
- Eliminate the manual, multiple touch points.
- Reduce purchasing cycle time and costs.
- Reduce off-contract or maverick spend.
- Improve quality.
- Tighten controls.
- Eliminate the "Black-Hole Syndrome"—lack of confidence in systems.

When performing indirect spend analysis, the concept of outsourcing the management and control of non-strategic purchases (competitive differentiators) was recognized as a viable solution.

The purchasing/supply organization began focusing on core competencies and competitive differentiators using a traditional 2x2 matrix (see Figure 12). When performing indirect spend analysis, the concept of outsourcing the management and control of non-strategic purchases (competitive differentiators) was recognized as a viable solution.

FIGURE 12 OUTSOURCE SELECTION MATRIX



TO OUTSOURCE OR NOT The decision to outsource a purchasing/supply function can be thought of as one of the last frontiers in outsourcing. The concern is that if a firm already outsources 50 percent of its cost of goods sold, of which 50 percent is indirect spend, the amount of cost of goods sold that are outside the company's control is a rather large percentage of everything that the company buys. Therefore, even though the goods and services that a third party may buy are not strategic, the very decision to allow someone else to carry out this function is, in itself, a strategic decision. With a high degree of introspection, the leaders from the firm's purchasing/supply and senior management group asked the following questions:

- Is managing indirect spend strategically important to our business?
- Do we have a single, centralized view of our indirect spend?
- Are we fully leveraging our indirect spend?
- Are our current processes "best sourcing" and "best supplier management" practices?

To effectively outsource, reduce cost, and manage the supply base, a sourcing partner was required with inherent capabilities to aggregate spend, a technology infrastructure, purchasing/supply processes, and strong sourcing expertise.

To effectively outsource, reduce cost, and manage the supply base, a sourcing partner was required with inherent capabilities to aggregate spend, a technology infrastructure, purchasing/supply processes, and strong sourcing expertise.

The company defined the desired characteristics of a Business Process Outsourcing (BPO) partner as:

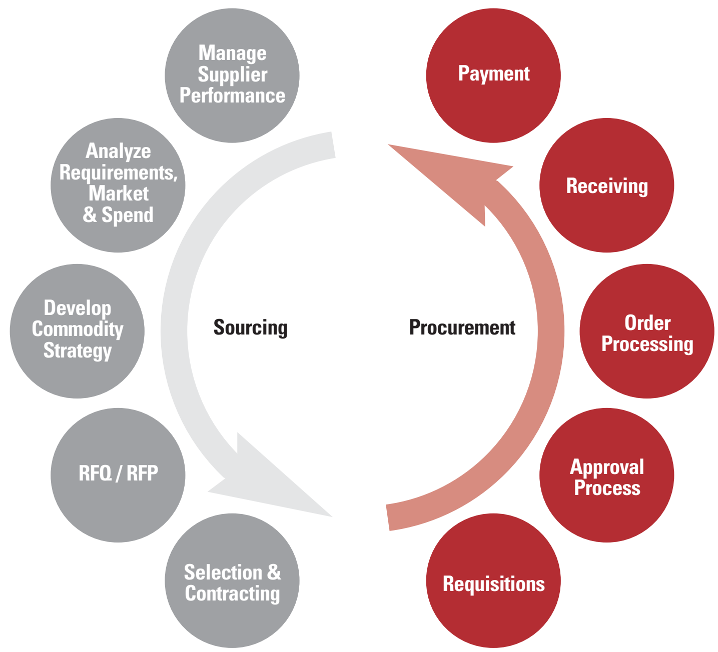
- Assistance in gaining control over indirect spend
- Demonstration of best practices in the complete purchasing/supply lifecycle
- Accountability for planning, execution, and results
- Innovation, out-of-the-box thinkers
- Being a nimble and responsive organization
- Maintaining human and knowledge retention when transitioning resources to retain business skills and knowledge

In addition, the company needed a good e-purchasing/supply catalog. The provider also had to be capable of selecting suppliers based on:

- Process capability
- Technology readiness
- Cost competitiveness

A marketplace review yielded few organizations with the complete complement of desired skills and infrastructure. Several global consulting companies demonstrated excellent sourcing skills, but did not demonstrate fulfillment or a complete purchasing/supply infrastructure, as shown in Figure 13.

FIGURE 13 SOURCING/PROCUREMENT CYCLE



THE OUTSOURCING SOLUTION During the review, one company was identified that potentially satisfied the BPO partnership requirements. This company's sole purpose was to provide outsourced purchasing/supply services to large electronic manufacturers. Another qualification of this provider was that it currently served customers with similar supplier markets. To complement this provider, smaller regional partners were also identified. It was felt that smaller providers might be able to provide more customized and better service.

The BPO partner was able to support a standardized e-catalog and acquire non-cataloged services. One of the major deciding factors was that key supplier relationships could still be maintained. In addition, the company, not the BPO partner, retained control of:

1. Procurement policies
2. Governance
3. Sourcing and procurement strategies
4. Supplier selection
5. Accounts payable activities

The company also incorporated delivery and inventory targets into the BPO arrangement.

The Business Process Outsourcing partner is managed as a single-source relationship. A formal performance scorecard is reviewed during weekly meetings and used to evaluate opportunities for increased levels of service.

The transition to an outsourced provider required a significant amount of planning and communication between the company and its suppliers.

TRANSITIONING The transition to an outsourced provider required a significant amount of planning and communication between the company and its suppliers. Suppliers were informed that the BPO partner was the company's agent. As contracts expired, the BPO partner contracted directly with the suppliers.

The company rollout began in the Untied States by commodity. In addition, the e-procurement system's implementation and support was outsourced.

ENABLERS There were several key enablers that facilitated the successful transfer from an inhouse to an outsourced purchasing/supply organization. They were:

- Establishing the "burning platform"—this is to ensure that everyone knew that the "old purchasing method" would disappear by a certain date. After that date, anyone that didn't know the new system would be at a severe disadvantage.
- Knowledge transfer by transitioning inhouse skills to the BPO partner—the company arranged for the BPO partner to hire many of the best indirect purchasing employees. This allowed the BPO partner to better serve the company.
- An inexpensive, working e-catalog—as seen in the previous case, why buy a Cadillac when a Chevy will do.
- An automated invoice system to increase user compliance.

In addition, if an employee purchases outside of the system, his/her supervisor has a "heart-to-heart" talk about the reasons to work within established processes.

RESULTS In the brief history of the BPO relationship, significant results and improvements have been achieved:

- Increased savings with decreased spend.
- Spend with preferred suppliers increased from 40 percent to 80 percent.
- Outsourcing fee is 60 percent less than were the internal operating expenses.
- A three-fold reduction in average purchase cycle times.
- Maverick spend has been reduced from 50 percent to 5 percent.
- There was a 125-person headcount reduction in North America. (Part of the saving was the ability to transition five legacy systems to Ariba. This represented 50 people.)
- Improved internal focus on strategic procurement.

- The BPO partner was able to leverage the company's spend with existing clients to further increase cost savings. Effects are similar to the creation of a marketplace.
- End user satisfaction has increased.

Deciding that drastic times called for drastic measures, the company's strategic sourcing group made the bold decision to outsource its indirect purchasing department. In doing so, it achieved some very incredible results in a very short period of time. In less than one year, this company was able to achieve the results some companies have spent years attempting to achieve.

However, the company now may be at the mercy of its BPO relationship. The attendees at the meeting raised several questions in this vein. Primarily, other strategic sourcing professionals were concerned with the BPO partner's ability to maintain a high level of service once it has a larger customer base. In addition, the switching costs associated with changing BPO partners are so large that the BPO partner could significantly raise prices over the life of the relationship. Lastly, some members wondered if the now smaller sourcing organization would be capable of fully overseeing the BPO partner's activities and recognizing fraud if it occurred.

In less than one year, this company was able to achieve the results some companies have spent years attempting to achieve.

CONCLUSIONS Indirect spend is fast becoming one of the more important topics in purchasing/supply. This white paper highlights the challenges associated with indirect spend and some methods that are currently being used to strategically manage and control these costs.

The four cases and the group discussions that followed identified nine enabling tactics that can help a company better manage its indirect spend. The nine enabling tactics are:

1. Zero-Based Budgeting
2. Pre-Budget Savings
3. Organizational Structure
4. Accounts Payable part of Purchasing/Supply
5. Training Power Users
6. Supplier Managed E-Catalogs
7. Commodity Coding for Indirect Spend
8. One Commodity Team for a Large Supplier
9. Outsourcing Indirect Sourcing

Likewise, *strategic sourcing* is quickly becoming one of the most important functions in a firm. This group is able to quickly add profits by decreasing the cost of inputs. More importantly, if managed correctly, the outsourced spend can be harnessed to align suppliers' interests with those of the firm by creating long lasting value for the buying firm. Until recently, indirect spend items have been relatively ignored by strategic sourcing groups. However, these groups are realizing that some of the same techniques and tools that have been applied to direct spend can be applied to indirect items. Once organizational, IT, and supplier management hurdles can be cleared, great savings can be garnered by the firms that strategically manage their indirect spend. ❖