“Perhaps more than any other area, the goal of spend analysis is the increased visibility that provides the means for improving spend and supplier performance within a procurement organization.”


Welcome to the first part of a 5-part “Focus on Fundamentals” series. The purpose of this series of white papers is to present fundamental skills, methodologies and best practices that procurement professionals can put into immediate practice within their organizations.

This first white paper focuses on spend analysis and addresses (3) key questions:

- What is spend analysis?
- How do you conduct a spend analysis?
- What do you do with the results of a spend analysis?

The motivation for conducting a spend analysis is well documented in terms of delivering significant value by optimizing costs and improving supply performance. In practical terms, a procurement organization conducting a spend analysis aims to achieve any or all of the following outcomes:

- Reductions in purchase price
- Reductions in total cost of ownership
- Reductions in supply risks
- Increased innovation from the supply market

In much broader context, spend analysis can be the starting point for developing effective procurement strategies to enable sustainable competitive advantage.

**What is spend analysis?**

Before discussing how to conduct a spend analysis, it is important to define what is meant by the term. For this series of white papers, spend analysis is defined as -

“a systematic process of collecting, cleansing and segmenting spend on suppliers with the aim of identifying the spend areas that have the biggest impact on profitability.”
This definition implies a holistic, topographic view of the company’s entire expenditure on suppliers. In some cases, this expenditure can be as much as 60 per cent or more of a company’s sales revenues. Therefore, data collection is one of the first challenges in conducting a spend analysis.

The second critical challenge involves defining specific spend categories by segmenting the entire expenditure on suppliers into supply market-facing spend areas. Creating these spend categories makes it possible for individual procurement teams to manage expenditures in the related supply markets as if they were managing an individual business unit.

Some large corporations have implemented fully integrated information systems that are capable of providing up-to-date, categorized, spend information extracted from multitudes of databases. However, the vast majority of companies today employ methods that depend heavily upon spreadsheets and other manual methods for collecting, categorizing and reporting spend information.

Even companies that have Enterprise Resource Planning (ERP) systems and other forms of business information systems may find that a significant amount of manual intervention is still required when undertaking a spend analysis exercise. This means that it is critically important to have a defined spend analysis methodology that isn’t necessarily dependent upon sophisticated software systems.

**How do you conduct a spend analysis?**

Although a number of approaches to conducting a spend analysis are in use, one well-established methodology involves the seven basic steps as shown in the figure below.

Now, let’s take a brief look at each of these seven steps.
Step 1: Collect the spend data

Spend analysis methodologies require - spend data. Spend data consists of all the items (including services) that have been purchased over a specified period of time. This data includes descriptions of the items, the quantities consumed, the purchase prices, the suppliers and other details.

So, where does this spend data come from?

In general, spend data is collected from a number of different sources, including - ERP systems, accounting, suppliers, sales and various stakeholders.

Once all the spend data has been collected from the various sources, it is often presented in a spreadsheet style matrix.

Individual items are listed in rows with columns containing all the spend data details relating to that item, as shown in the figure above.

Step 2: Cleanse the spend data

Once the spend data has been collected, it must be cleansed. This involves a variety of checks on the data, such as checking:

- The total amount
- Whether all suppliers are included
- Identifying duplicate suppliers
- Normalizing prices to exchange rates
- Etc..

The aim of the step is to produce a clean data file that accurately and reliably reflects the entire company spend. Although a number of
software tools are available to assist with this step it is generally not possible to eliminate human/manual intervention.

**Step 3: Classify the spend data**

Classifying the spend data is the step that follows spend data cleansing and involves linking each item in the entire spend to standard classification codes. Examples of standard classification codes include:

- Company Specific Classifications (i.e. defined by the company)
- North American Industry Classification System (NAICS)
- eClass Code
- United Nations Standard Products and Services Code (UNSPSC)

The UNSPSC contains over 50,000 codes and is regularly updated. Using standard classification codes like the UNSPSC is an established best practice. However, many companies chose to use their own system of classification codes.

Regardless of the classification coding scheme, the key aim of this step is to produce a spend data file with each item (i.e. each row) linked to a unique classification code.

Spend analysis software can also be of great help in this step.

**Step 4: Detect the addressable spend**

Not all of the entire spend will be available for cost optimization. Some of the spend will be impossible or extremely difficult to influence in any meaningful way. Examples of this kind of spend include: taxes, rent, and governmental charges. Once these non-addressable spend items have been identified and removed then addressable spend items remain.

**Step 5: Define the categories**

Now that the spend data has been collected, cleansed and classified and the addressable portion of spend has been identified, it is time to
cluster the addressable spend items into categories. This step of segmenting addressable spend into categories must be performed in a way that reflects or mirrors how individual supply markets are organized. This step is particularly important because it creates the link between related areas of spend and the supply markets.

So, for example, spend on hotels, airfare, rental cars, etc. could be clustered together as sub-categories (related areas of spend) to form a “Travel” category facing the travel agency supply market. See this illustrated in the figure below.

When clustering together sub-categories of spend into supply market-facing categories, care must be taken to ensure that the monetary value of the resulting spend categories are above a minimum. This minimum value will vary from one organization to another but in general it must be large enough to work on from a cost optimization perspective.

Performing this step correctly requires careful examination of the data and judgement concerning the items to be clustered together. However, it is critically important to perform this step correctly because of its influence on the benefits that can be later realized.

**Step 6: Select the high impact spend**

In this next to last step of the spend analysis, focus shifts from data manipulation and category creation to identifying those categories that have the most potential for delivering benefits to the organization. In other words, it is now time to select the high-impact spend.

After sorting the data in terms of spend amounts (high-to-low), a useful tool for selecting high impact spend is ABC-analysis.
The idea behind this analysis is that 80 per cent of the entire spend is usually linked to about 20 per cent of the number of categories. This is the “A” group of categories.

An additional 15 percent of the entire spend is then linked to another larger grouping of categories. This is the “B” group of categories.

Finally, the remaining 5 per cent of entire spend is linked to the remaining group of categories, this being the “C” group of categories.

ABC-analysis facilitates differentiation between the categories so that it is possible to focus on just those categories having the highest impact on spend. These high-impact spend categories are the input to the final step in the spend analysis.

**Step 7: Execute the opportunity scan**

The seventh and final step is referred to as an “opportunity scan”. A special matrix is constructed to perform this step.

The y-axis of the matrix represents potential benefits from small to big. Potential benefits include potential savings obtained through the reduction in price or the reduction in total cost of ownership. It also
includes potential savings from efficiency gains, reduced risk or increased value.

The x-axis of the matrix represents the ease of implementing changes in the current supply structure, from hard to easy. Ease of implementation includes the ease to bring change to the organization and the ease to realize the estimated benefits.

The resulting matrix consists of four quadrants:

- Priorities
- Worth the effort
- Maybe
- Avoid

The various categories can now be placed inside the matrix with priority given to Group A categories since these categories have the
highest impact on entire spend. See figure to the right showing example categories placed on the opportunity scan matrix.

Associating potential benefits and ease of implementation with each category typically involves interviews with stakeholders, suppliers and various members of the organization. These interviews enable the spend analysis team to identify those categories that should be prioritized or avoided as a focus for cost optimization and/or supplier performance improvement.

What do you do with the results of a spend analysis?

Once the opportunity scan has been completed and priority categories have been identified, the spend analysis exercise is effectively concluded. The results of the spend analysis provide a starting point for developing effective procurement strategies to capture and monetize the potential value the analysis uncovered. These strategies could range from adopting a different category management approach to negotiating stricter terms with suppliers whose markets have experienced increased competition.

In the next part of this series we take a close look at “Procurement Finance” within the aim of providing some fundamentals to help build bridges between procurement, finance and accounting. A pdf copy of this white paper is available for download from our website - here.
About the Author

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About Procurement Academy

Established in early 2008 by former international procurement leaders, Procurement Academy is an online E-Learning company specializing in competence development for large and/or multinational procurement staff. Our High-Impact E-Learning courses are an innovative fusion of procurement best practices and advanced learning theory that enables procurement organizations to deliver more value through superior competence.

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