

# A CFO's Guide to Cost Saving Opportunities in Procurement

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At a time when CFOs are taking ever greater responsibility for their procurement functions, it is vital to be aware of the related challenges and opportunities. After all, cost saving targets are such that there is little room for experimentation. Here, EquaTerra presents CFOs with a step-by-step guide to realising the huge potential that procurement transformation can offer. This should be of particular value to organisations lacking the size to sustain a dedicated chief procurement officer (CPO) and who are seeking an alternative to staff reductions as a means to achieving savings.

An understanding of the opportunities (and how to realise them) can be achieved through conducting two phases of analysis:

1. Internal assessment phase
2. Sourcing evaluation phase

Each phase requires a number of key questions to be addressed. While the objective of the first phase is to determine the size of the opportunities, the second phase is aimed at evaluating the external solutions which serve to realise these opportunities. This approach will help CFOs in outperforming their peers by achieving 'top' performance, in contrast to 'average' performance, as shown in figure 1 below.

The proposed approach is based on EquaTerra's extensive experience in the outsourcing industry, combined with valuable input provided by procurement specialists from a sample of service providers (Accenture, IBM, Genpact, TCS and buyingTeam), each providing their unique view on what key cost saving opportunities currently exist and how these can be realised.

## Typical Performance Statistics (Relative to Total Indirect Spend)<sup>1</sup>

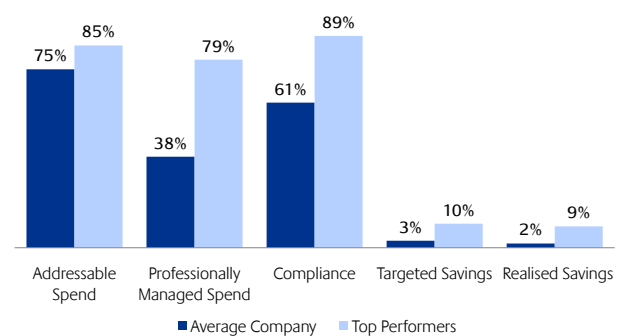


Figure 1

<sup>1</sup> Source: "EquaTerra Perspectives: Procurement Outsourcing", June 2010

## 1. Internal assessment phase

In order to identify the opportunities and their scale, a thorough internal assessment should be conducted, giving careful consideration to how the procurement function is currently operating. Case studies of ‘top performers’ in the public domain have shown that assessments of this kind can result in the identification of cost savings which are in the region of five to 15 times as large as the associated investment required.

The range of the procurement function’s responsibilities is shown in the figure below (commonly referred to as Source-to-Pay). However, as the questions raised in section c) and d) below will illustrate, procurement’s responsibilities extend much further; covering all interactions with the internal organisation.<sup>2</sup>

Accounts payable	Procurement operations	Strategic sourcing
<ul style="list-style-type: none"> <li>• Receive and scan invoice</li> <li>• Match invoice with order and receipt</li> <li>• Resolve inconsistencies</li> <li>• Resolve compliancy issues</li> <li>• Book and initiate payment</li> <li>• Provide detailed spend report</li> </ul>	<ul style="list-style-type: none"> <li>• Create/manage online catalogues</li> <li>• Process purchasing requests, create and submit purchase orders (POs)</li> <li>• Manage offline purchases</li> <li>• Perform tactical/spot buys</li> <li>• Manage supplier and contracts databases</li> <li>• Track supplier performance</li> <li>• Manage compliance</li> </ul>	<ul style="list-style-type: none"> <li>• Analyse spending</li> <li>• Manage demand</li> <li>• Develop sourcing strategy</li> <li>• Perform Request for Information (Rfi), Request for Proposal (RfP) and/or an electronic equivalent</li> <li>• Negotiate and establish contract</li> <li>• Category management</li> <li>• Supplier Relationship Management (SRM)</li> </ul>

Below are the questions that CFOs should address as part of the internal assessment, plus our recommendations for how best to address them individually. Each question covers a particular aspect of the set of responsibilities of the procurement function.

### a. “Are our internal processes efficient?”

Efficiency is most relevant when evaluating transactional processes. Of all processes that are commonly associated with procurement, the accounts payable process is by far the most transactional (although this process often resides in the finance rather than procurement function). Typical indicators that are used in benchmarking accounts payable include: cost per invoice processed, cost per PO processed, the degree of automation and the number of processed invoices per full time equivalent (FTE). When these figures are available, they should be benchmarked against market figures, which will give an understanding of how efficiently the accounts payable process is currently operating. There is also a transactional component to procurement operations, such as researching commodity markets and managing supplier and contract databases. However,

<sup>2</sup> Also see EquaTerra’s white paper titled ‘Leading the Outsourcing Agenda: A Procurement Opportunity’

efficiency in these processes is often harder to measure without engaging directly with the market. A 'market test' could be set up to convey how efficient current procurement operations are. An alternative which has recently emerged is nearshore delivery.

Because transactional processes are often delivered from offshore locations, a market test might reveal large opportunities for efficiency gains. However, it is important at this stage to note that the concept of offshore delivery has its obvious pros and cons, which should be carefully assessed in the context of the organisation's culture and risk appetite.

### **b. "Are we doing a good job at managing our suppliers?"**

Managing suppliers is a part of both 'procurement operations' and the 'strategic sourcing' elements of the procurement function. This entails activities such as managing contracts and service levels, identifying supply chain risks, as well as managing relationships with strategic suppliers. Since the nature of this work is relatively knowledge intensive, the opportunity assessment will require the (tacit) knowledge of category managers. The potential cost savings in the spend which they are currently managing can be identified by hiring external analysts to review their performance.

When it comes to spend categories which are currently not managed, the assessment will require a slightly different approach. What is required for this assessment is spend visibility. In categories such as IT and professional services, often a significant part of total spend is not being managed by procurement. Depending on the size of the total spend to be assessed, it will require significant time to achieve the desired visibility. However, an assessment of non-managed spend will render procurement opportunities which are usually much higher than those for spend currently managed.

### **c. "Are we doing enough to ensure compliance?"**

According to the sample of service providers which provided insights for this article, compliance management improvements account for almost half of total potential savings for client organisations. Therefore, it is evident that the baseline compliance rate needs to be accurately estimated within each category of spend. One way in which compliance can be stimulated is by having a service catalogue in place which is based on the appropriate level of specification for the end user. Another way is by having an easily accessible buying channel in place. In any case, the objective of this assessment should be to find ways in which to reduce maverick spending to a minimum for the targeted categories. In addition, it is important to safeguard any compliance improvements over time, to prevent any leakage from occurring once people return to the 'business as usual' mindset.

#### d. “Can we expand our services to deliver more value to our internal clients?”

There are two dimensions that should be considered when executing this final part of the assessment. Firstly, the percentage of spend being managed by procurement (‘size of the pie’) has to be calculated. According to EquaTerra research, prior to any initiative, less than half of total indirect spend is usually managed within the typical business unit. The relative autonomy of business units or geographies in managing their spend independently contributes to this percentage being relatively low. As a CFO, it is important at this point to note that any negotiated savings apply only to the percentage of spend which is actually being managed by procurement.

Secondly, for the spend under management, the relative level of involvement of the procurement team should be assessed (‘portion of the pie’). To clarify, the potential scope of involvement ranges from engaging with the end user to determine the specifications, all the way through to closing the payment - in other words, from ‘source’ to ‘pay’.

#### Typical Resource Allocation

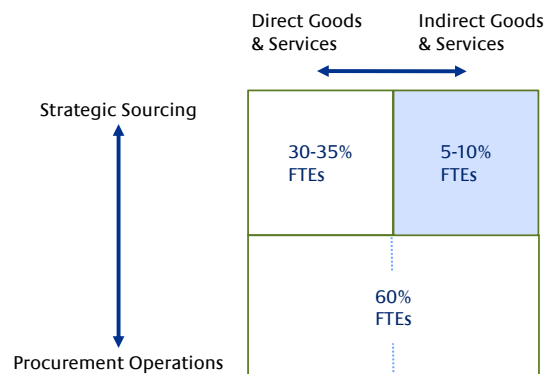


Figure 2

Typically, the resource allocation in spend management looks similar to what is shown in figure 2. It shows most resources are allocated to procurement operations (60 percent), while the remaining resources are allocated to strategic sourcing activities. Often the allocation of strategic sourcing resources does not reflect the actual size of the spend parts of the portfolio being managed. In particular, the number of resources allocated to indirect categories is too small, and their focus is fragmented, considering that they have to manage:

- Dozens of categories with hundreds of specialised sub-categories requiring unique market intelligence
- Thousands of suppliers with multiple, non-standardised contracts
- Tens of thousands of product and service specifications
- Thousands of end users with as many points of leakage

It becomes apparent that the typical resource allocation will need to shift in order to reflect the relative effort required in managing indirect costs. Moreover, to accommodate any increase (be it in 'portion' or 'size' of the pie) in services offered by procurement, the total number of resources will also have to increase in order to achieve the desired cost savings. Once the information requirement for the assessment phase is fulfilled, the only unknown in the formula below is the 'savings rate by category'. Depending on the current maturity of the procurement function, together with the sustainability of the initiative, this rate has been conservatively estimated to be 9 percent of total indirect spend, across categories (for the top performers).

$$\text{Achieved savings} = \sum \text{Addressable spend by category} \times \text{Percent managed By category} \times \text{Savings rate by category} \times \text{Compliance rate by year, category region \& BU}$$

The next (crucial) question is how to realise the full savings potential. Multiple options exist, ranging from 'make' to 'buy' solutions, each with its advantages and disadvantages. Often, no clear cut solution is available, as organisations have unique characteristics and challenges. Sourcing advisors are uniquely positioned to assist CFOs in making the right decisions.

When an organisation is risk averse but has high internal change capacity, internal solutions could be optimal. However, such solutions require continued executive sponsorship and extensive CFO support. Alternatively, for less risk averse organisations, engaging external service providers is very likely to be beneficial. The next section sets out which 'external options' are available to elevate the performance of the procurement transformation journey.

## 2. Sourcing Evaluation Phase

Once the internal assessment is completed, the CFO should have an understanding of where the major cost saving opportunities are. But how can you turn these opportunities into savings that will hit the bottom line? The answer depends on the availability and capability of internal as well as external resources which can drive transformation. Typically, top performers engage in some form of outsourcing to fuel their procurement transformation journey. The purpose of the 'sourcing evaluation' phase is to find the optimal mix of maximising organisational comfort versus maximising cost savings (see figure 3). EquaTerra has found that reducing total cost of ownership, enabling transformation and redirecting focus to more strategic activities are the main drivers for procurement outsourcing (see figure 4).

Procurement Sourcing Strategy Decision Factors

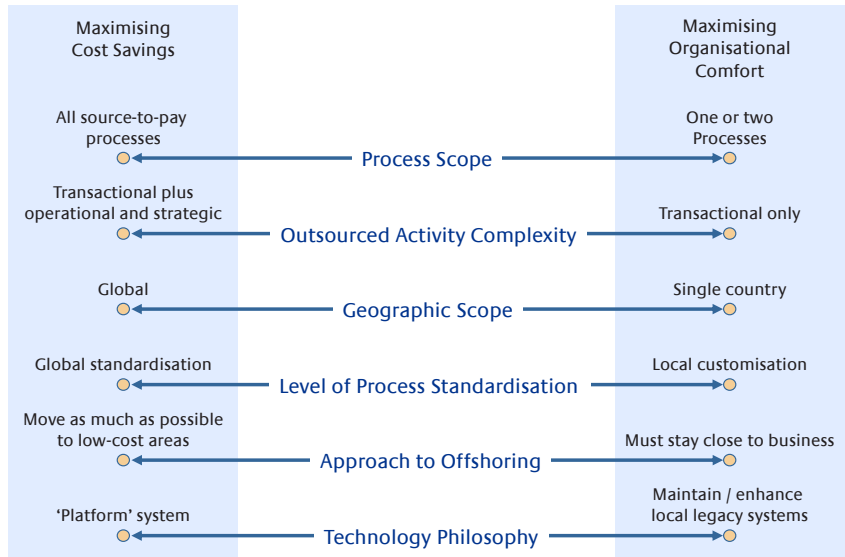


Figure 3

Why Procurement Outsourcing?<sup>3</sup>

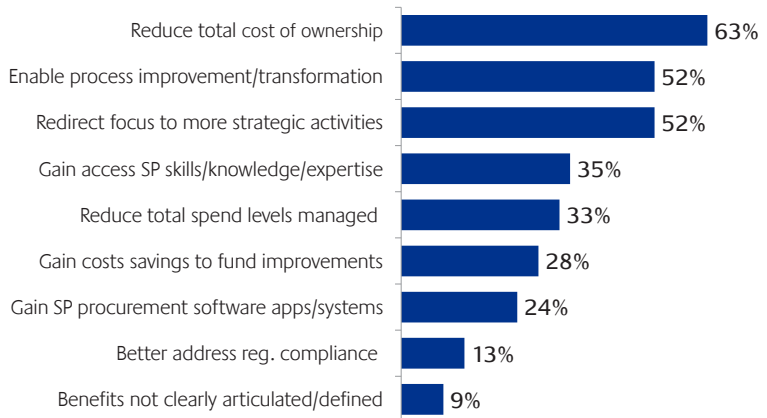


Figure 4

Keep in mind that outsourcing requires a considerable investment (for selecting, contracting and managing the service provider), which is higher than the level of investment required for internal transformation. Moreover, the market for procurement outsourcing is relatively immature (as the recognition by service providers of 'procurement' as a separate function is only a recent phenomenon). However, case studies have shown that the additional investment can trigger impressive levels of savings in the longer term, and realise them earlier than when the transformation is managed internally.

<sup>3</sup> This graph stems from a study which was conducted in October, 2009. The data was collected from 164 respondents at EquaTerra, SIG and SCMI (Supply Chain Management Institute) networks. 63 percent of respondents resided in end-user organizations, 20 percent in business and IT service providers, 17 percent in third party sourcing advisors, consultancies or law firms.

Procurement outsourcing might be required when implementing each of the following four transformation elements:

1. Efficiency gains in the internal transactional process
2. Supplier management
3. Compliancy management
4. Expanding procurement services

With regard to efficiency gains, one of the obvious opportunities is to move delivery of transactional work to an offshore location, realising labour arbitrage by doing so. The traditional outsourcing giants have the required offshore scale to deliver cost savings, with relatively low investment requirements for buyers. Outsourcing partners add value by bringing more investment to the table, carrying more risk and bearing most of the burden of continuous improvement requirements over time. Alternatively, a captive centre could be set up. This solution will be suitable when the transaction data is highly sensitive to leakage and/or when the desire to retain control is high. Other decision factors include: the organisation's ability to attract and retain procurement talent, homogeneity of culture and procedures, willingness to invest, internal processes and technology maturity. When engaging an external party, ensure appropriate service levels and metrics are linked to business outcomes. Also consider what investments are required in terms of technology; do current systems suffice or would the initiative benefit from being accompanied by a whole new procurement platform? A platform solution could be worth considering, as it typically replaces any legacy software and links together all procurement data within the organisation to facilitate day-to-day procurement operations, as well as strategic decision making.

When it comes to the other three opportunities (b, c, d), help of a different kind could be required. The sourcing decision here should not be based on the scale of capabilities in the market, but rather on the depth (i.e. capabilities in terms of knowledge and expertise). Niche players have a smaller scale than the industry leaders, but more in-depth knowledge of how to deliver sustainable change with regard to the role procurement has within the wider organisation. It is important to consider that changes are required to be sustainable over time, in order for the initiative to deliver its potential value. For example, implementing a new service catalogue to ensure better compliance will not be sustainable if fundamental organisational change is not implemented. Another consideration at this point is alignment of internal stakeholders (who could be facing a reduction of autonomy, stemming from this initiative). It is advisable to (in an early stage) engage in stakeholder discussions. Stakeholders can be reassured if the benefits of the initiative are clearly explained, if the range of affected categories is clearly defined and if the specific (local) procurement requirements are set out.

Responsibility for delivering all four elements of the initiative could be transferred to a single service provider. However, some service providers specialise in transactional efficiency or delivering in-depth category expertise, while others specialise in transforming the procurement function. Therefore, the optimal sourcing solution might involve more than one service provider.

In conclusion, the opportunities for transforming the procurement function are significant and deserve the full attention of the CFO. We have described the four distinct facets which are crucial for delivering top performance: becoming more efficient in managing transactions and more effective in managing suppliers and compliancy, as well as expanding the procurement services within the organisation. A range of 'make' versus 'buy' options exists to deliver successful transformation and today's savvy CFOs are realising that the savings potential is too large to ignore.

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