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“Off the Table,
Into the Pocket”
*Driving Procurement
Savings to the
Bottom Line*



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“Off the Table, Into the Pocket”

Driving Procurement Savings to the Bottom Line

With companies dead set on cutting costs and becoming more efficient, it's no surprise that corporate procurement has come under the microscope. Indeed, many companies have made significant strides in refocusing their purchasing efforts to be as frugal as possible. Motorola Inc., which spends an annual \$18 billion on materials and services, has set a three-year goal of \$1 billion in savings; Matsushita Electric Industrial Co., the world's largest maker of consumer electronics, is working toward cutting group procurement costs by 10.5 percent, or \$4 billion, by March 2005; and Microsoft aims to cut spending by \$1.4 billion in 2005 from its annual total of \$11.5 billion.

But there is a big gap between what is identified as savings and the amount that actually drops to the bottom line. Despite their best intentions, too many companies soon discover that, somehow, a large proportion of the savings their procurement executives promised seems to leak away. In fact, our experience indicates that most companies realize no more than 50 percent of the procurement savings they planned for. Others see an even more dire situation. According to research by the Center for Advanced Purchasing Studies (CAPS), nearly 50 percent of U.S. corporations' revenue in 2004 went toward the purchase of goods and services, and corporate purchasing departments managed more than 80 percent of those expenditures. Yet, corporate-wide savings programs were able to realize cost cuts of only 5 percent of total procurement spending, CAPS also reports.

If your company is like most, you've no doubt heard many of the typical complaints:

“My head of procurement is claiming €250 million in savings a year. I've asked him why I could not see this in the profitability of the divisions. He said he doesn't know. He assumed the divisions are compromising his savings by spend increases and unauthorized 'maverick buy' from local suppliers.”—CEO, Global Logistics Provider

“We made significant strides in reducing our costs for procured marketing materials and services—reaching up to 50 percent in cost reductions in some cases and achieving an almost 10-fold increase versus our target. Unfortunately, we had no mechanism to affect the already established budget, so all the incremental savings were quickly spent.”—Head of Purchasing, North American Consumer Products Company

Clearly, the impact from savings leakage in procurement efforts can be significant. So significant that finding a way to plug the holes and minimize the leakage is just as important as the process of identifying and executing procurement savings in the first place.

The good news is that the problem of leakage can be fixed. The “fix” takes a number of cues from the way many companies successfully approach any large cross-functional cost-reduction initiative, where a set of explicit execution, decision-making, and tracking mechanisms have been put in place. Without such structures, no focused savings program—whether it is a one-off savings initiative or a normal, day-to-day procurement effort—will fully produce its intended results.

Why Leakage Occurs

Essentially, leakage is the result of four factors (the first three are closely related to the lack of buy-in between procurement and the affected functions or divisions):

1. *Overestimating:* Too often, the assumptions used to project procurement savings are simply too optimistic

or too aggressive. Such assumptions typically arise because they're based on poor benchmarks and incomplete understanding of current and forecasted spending or incorrect assumptions about the cost drivers that affect savings—such as supplier economics. Ultimately, such problems result from a lack of general rigor and departmental input into the underlying assumptions.

2. Budgeting: Once a particular department determines its expected savings, those expectations can be intentionally “watered down” when they are incorporated into departmental budgets—the goal being to provide a budgetary cushion to make sure budgeting expectations are met. Again, lack of organizational buy-in typically leads to this behavior. The result: The full amount of the expected savings never appears. A corollary to this tactic involves the lack of a mechanism for capturing the additional savings created—but not budgeted for—if the savings initiative exceeds expectations. In this case, although the exact target savings are achieved, any additional savings are simply spent elsewhere.

3. Demand Management and Compliance: Another common route by which savings leak away appears when the company starts buying products from vendors other than those determined by the procurement process. Instead of a 20” x 20” poster in black and white, marketing may purchase a 31.5” x 43” full-color, embossed poster—from a vendor that does not have the best negotiated prices and isn't on the approved list. Unless these “off-plan” decisions are made with a clear picture of the business trade-offs and the impact on targeted savings, then functional/divisional budget owners may seek less than optimal solutions for the company as a whole, with a net result of further savings leakage.

4. Changes in Baseline Assumptions: Despite the best intentions, you can never escape the effect of inflationary pressures; for example, when increases in raw material costs and wage rates generate higher prices to vendors that are then passed on to you. To further complicate matters, your company may change what it is buying, and from whom. In either case, it is critical to have a well-documented baseline that allows you to explain the impact of such shifts and account for them when discussing the actual savings achieved.

We have identified *six elements* that must be in place to minimize leakage and maximize the delivery of

savings from procurement programs to the bottom line (see Exhibit 1). Three of the elements—initiative definition, “strong-form” budgeting, and well-defined measurement and tracking—are tactical and require hard-wiring and some modification to the existing processes. The other three—commitment from senior managers, cross-functional engagement, and the process of brokering and decision rights—are “softer,” company-wide elements, but they are no less critical to maximizing the savings potential and making savings stick (see *Plugging the Holes*, page 5).

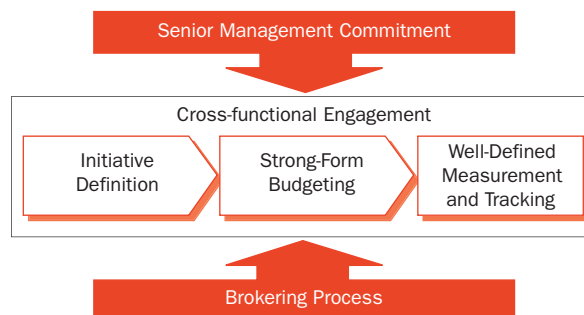
“Hard” Tactical Challenges

No procurement spending initiative can succeed without resolution of the softer organizational issues. However, the tactical, business-process challenges are an even more critical factor in making sure such a project succeeds.

1. Initiative Definition. Transparency is necessary to ensure adequate clarity and is an important basis for any internal brokering and negotiations in the future, whether for ongoing procurement savings efforts or as part of a major, focused initiative. Structured tools, such as the “Project Sheet” (see Exhibit 2, page 3), help with scope definition. Use of such a tool also ensures that the savings process is sufficiently documented, so that clear responsibilities, targets, milestones, and baseline assumptions are understood by all—including procurement, finance, and the individual departments.

The specific goals of the initiative definition concern assigning accountability, determining decision-making responsibility, setting timing, and creating savings targets. Key activities:

Exhibit 1
Minimizing Procurement Savings Leakage



Source: Booz Allen Hamilton

Exhibit 2

Sample Project Sheet—Illustrative

Procurement Savings Initiative Project Sheet

Commodity Project Title Savings Levers	Industrial Supplies	Team Members			
	Development of Preferred Vendor	Jay Doc (Procurement), Pat Dodd (Maintenance), Jane Jones (Manufacturing), Pete Franklin (Finance)			
	Spend Consolidation				
Milestone Activity	Planned Date of Completion	Savings Summary (\$ millions)			
Kick-off	April 1		Year 1	Year 2	Year 3
Baseline Approval	April 21	Target	\$0.6	\$1.1	\$1.3
RFP Development/Issue	May 15	Achieved	\$0.3	\$1.4	\$1.5
RFP Analysis	June 7	Budgeted	\$0.3	\$1.0	\$1.2
Negotiations	July 15				
Supplier Selection	July 31				
Savings Start	September 1				
Baseline Assumptions		Issues			
Baseline unit pricing from sample invoices		30 percent response rate on RFP requiring extension of timeline to allow more responses			
Forecast volume based on baseline volume adjusted for % sales forecast increase					
Scope covers all 6 facilities in U.S. (5 Plants and HQ)					
Notes/Comments		Risks			
Need to respond to questions submitted by RFP respondents		Many products in category (paint, plastics, lubricants, etc.) are petroleum based and therefore subject to significant price increases in the short-run, potentially minimizing or eliminating "cash" savings			
Draft responses to supplier questions and get input from functional team members before sending					

Source: Booz Allen Hamilton

- Documenting who is responsible for what and defining the cross-functional teams.
- Clarifying spending assumptions from which savings expectations can be explicitly measured.
- Committing to a schedule, including specific milestones, for execution.
- Establishing savings targets to be tracked against savings achieved.
- Setting up a system in finance to monitor whether procurement's targets for project costs and savings are being met.
- Finance must clearly link the savings initiative to the functional/divisional budgets.
- Adjustments to the budgets must be allowed to incorporate changes in the savings targets—if only in a shadow process—to create a truer measure of actual versus expected spend (see Exhibit 3). Thus, if savings exceed the originally budgeted amount, the plan would be adjusted accordingly. For example, if the final outcome of a rigorous RFP and negotiation process yields savings that are higher than originally estimated, this upside needs to be captured in the budget or the savings will "fall off the table".

2. *Strong-form Budgeting.* Fundamental to the whole procurement savings process is rigorous budgeting. As a rule, budgeted savings will guide maximum savings. Set the budgeted amount of savings too low, and you will most likely not see much in savings. The budgeting process sets the commitment early on and allows for visibility into realized savings. The budgeting process also provides the framework within which all departments and functions must work with procurement to achieve the targeted savings.

Two additional elements are critical if the budgeting process is to be effective:

Exhibit 3

Impact of Savings Target Changes on the Budget

Pre-Initiative Completion

Original Budget	Savings Target	Adjusted Budget
\$1,000,000	\$100,000	\$900,000

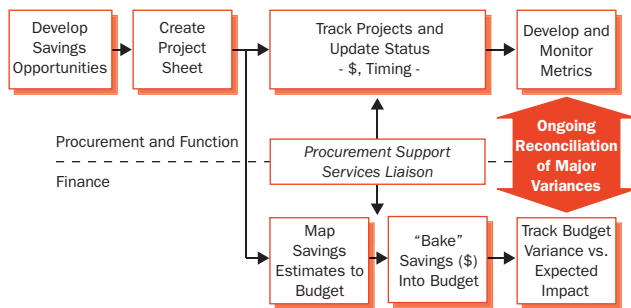


Post-Initiative Completion

New Savings Target	Latest Budget Estimate	Actual	Variance
\$200,000	\$800,000	\$650,000	(\$150,000)

Source: Booz Allen Hamilton

Exhibit 4 Savings Measurement Tracking



Source: Booz Allen Hamilton

3. Well-defined Measurement and Tracking: Poor measurement and tracking of current spending and future savings is the bane of most procurement savings efforts. It is always difficult to isolate and “see” the savings that have actually fallen to the bottom line despite cross-functional teaming, a clearly documented baseline, a well-defined savings initiative, and a well-designed budgeting process, even if savings goals have been achieved.

Savings can disappear for many reasons, some manageable (e.g., maverick buying or specification changes), and some unmanageable (e.g., inflation or changes in demand). Critical to knowing you have captured the anticipated savings is creating visibility into the savings identification process and successfully managing the link between finance and procurement (see Exhibit 4). Several processes need to be in place for this to happen:

- **Project-level tracking by procurement.** The procurement function must accurately track the overall progress of the project. The Project Sheet used to help define the initiative can also be used for monitoring. Such a tool captures procurement’s progress and compares it with established milestones.
- **Linking all budgetary adjustments to departmental budgets.** This process allows for savings to be “baked into” every budget. Adjustments are made for changes in baseline assumptions as well as for the impact of increased savings and then tied back to individual procurement project tracking sheets.
- **Tracking of actual savings against budgeted savings on an exception basis.** Broad variances from planned savings and consequent impacts on budgets should be

highlighted; price and volume variances need to be normalized as appropriate to check for true procurement impacts.

- **Monitoring of commodity dashboards.** Drivers of deviation from expected savings results can be explained—e.g., volume, specifications of the product mix, vendor changes from original plan and baseline—and reconciled with the exception-based tracking by finance.

“Soft” Organizational Challenges

No enterprise-wide savings initiative has much chance of succeeding if organizational issues have not been dealt with. Such issues invariably involve what might be called “politics”: top-management leadership, inter-departmental buy-in, and consensus on decision rights.

1. Senior Management Commitment. Nearly every significant purchasing initiative works across organizational and functional boundaries to drive savings within budgets that purchasing does not own. And because it is often so difficult to get cooperation among diverse departments, such initiatives must make sure they have executive-level sponsorship at the highest level of the organization in order to manage the process through any potential organizational friction and provide the necessary incentive for change.

2. Cross-functional Engagement. Similarly, because procurement itself does not own a budget and has limited decision-making authority, cross-functional engagement is a key element for success. Indeed, it is required throughout the specific savings initiative—from the initial identification of potential savings (baselining, savings identification and estimation, RFP development, and negotiations), to the embedding of the expected savings in the appropriate budgets, to measurement and tracking of the results.

3. Brokering Process. Given the divergent views between procurement and the functions on purchasing savings, it is critical to have a process for resolving stalemates that arise during decision making, and to arrive at the right business decisions without stumbling. Such a process will often require an executive body or committee to make decisions or establish and clarify such rights. Decisions come in many forms: Is the savings initiative worth pursuing? What resources should we dedicate to the effort? How much of the expected savings should we budget? Should we budget

Plugging the Holes

Consider the typical, yet challenging, example of achieving savings in the area of marketing, and specifically media buying. Let's assume that through supplier interactions and economic analysis, procurement actually identifies significant savings opportunities along several fronts—switching to a lower-cost but higher-value media buying agency; instituting specific demand-side savings opportunities, such as volume commitments, regional splits, and lower cost designs. If you think the savings will make it to the bottom line in the absence of the *six elements to minimize leakage*, think again.

First, the agendas of the marketing and procurement departments are inherently at odds, and no savings will be achieved without aligning those incentives and objectives. Therefore, step one is to *secure management commitment* and *establish a cross-functional marketing/procurement team* for the initiative.

But even though marketing is part of the project team, there's no guarantee that the department will not seek to minimize the savings opportunities; after all, its argument will be that any such savings will adversely affect the creative product. Here is where the *brokering process* comes into play: Someone needs to break the tie, either by committee or through explicit decision-making authority.

Media buying is a budget-driven spending category in which savings typically mean that you get more to spend to hit the budget, so \$5 million in savings really means \$5 million more to spend. Therefore, unless the budget is adjusted to compensate for the money saved—unless *strong-form budgeting* is practiced—the savings will simply evaporate. Again, senior management brokering and cross-functional teaming will help to avoid this problem.

Then comes the argument that a changing media buying environment requires additional spending or requires savings to be allocated differently—“What was the basis of savings measurement? Well, we're operating under different conditions now, so we can't possibly save what we said we would.” Here is where *initiative definition*, including savings targets, project milestones, and baseline assumptions, must be clearly articulated. If not, prepare for slippage in both execution and the ability to measure performance.

Finally, even if all else goes well, to truly identify the savings you have captured, you need to be able to clearly *measure your results* against the original plans and assumptions. True, that's more easily said than done, but if you don't figure out how to measure the variance, you'll never fully understand why the savings were or were not achieved. Was it a change in the spend assumptions? Did you buy what you said you would, and from the suppliers you said you would use?

“stretch targets” to provide greater incentive to save? What should we do with excess savings: reinvest them or bring them to the bottom line?

Getting money into your company's pocket is just as difficult as putting money on the table—and in our experience worth just as much. No matter how skillful your procurement organization is at finding and negotiating savings, a flawed process of defining and capturing those savings can significantly hamper your

ability to realize those benefits and may negate any sourcing advantages you might have negotiated.

It's more than likely that any company that has led a successful, cross-functional cost-reduction program in any area has experienced the elements required for procurement savings success. The challenge, however, is in instituting the elements of the savings process as a matter of ongoing business practice—hard-wiring the process and changing the organizational approach.

Instituting these changes can lead to significant increases in the amount of money that makes it to the bottom line of the company. With many companies experiencing a near 50 percent leakage of savings identification and capture, even a slight improvement

will translate into big benefits—benefits that are worth the initial organization friction to change. In the end, it's not magic, but rather a whole lot of discipline and organizational buy-in that is required to move the money off the table and into your company's pocket.

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