

WHAT ARE THE TOP TEN PERFORMANCE INITIATIVES THAT CHIEF PROCUREMENT OFFICERS (CPO) SHOULD USE TO OPTIMIZE VALUE IN SUPPLY MANAGEMENT?

VALUE STATEMENT INTRODUCTION

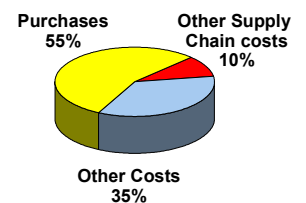
Procurement and supply management professionals operate in a highly competitive and visible environment. The past decades have put an increased demand on the contributions from Supply. Many enterprises now see that contribution as the most critical factor in continued prosperity and growth. While Supply management contribution is best optimized as a trade-off between Value and Risk, the recent emphasis has been on the Value side of the trade-offs. This is changing.

For the last fifty years the global economies have benefited from the stability afforded by the longest period of uninterrupted economic advance. The compromise of communism, the market-driven economies in China and India, the break-up of colonialism in Africa, and the growth of economic communities in Europe, South East Asia, Africa, and the Americas have all encouraged an open society. Innovation, sourcing, finance and technology now flow as freely in Dubai and Dublin as it does in Detroit.

Globalization has resulted in lowering the over-all costs; but that has occurred in a stable world environment. The world is no longer stable. The scope of Supply management sources and the markets are global; so is the Risk. There must be an impact to Supply relationships associated to the higher level of risk of a global Supply chain. The world is at Risk and Supply management is not exempt.

Globalization is demanding that supply professionals manage better. The most critical aspect of Supply management is avoiding disruptions to the continuity of supply.

Companies cannot afford not to invest in the systems, the infrastructure, or the people. Today, many companies have realized that this has to change and the CPO is leading the initiatives. Many CPOs are aware of this shift in the attitude towards the Supply Management function. Unfortunately, the majority of CPOs are dissatisfied (a) with the contribution being made by their Supply Management function, and (b) with their own inability to measure the value contributed by that function. Surprisingly, the majority of the managers who run Supply Management functions are equally dissatisfied by these same two issues.



Supply Management is the highest percentage of expenditures of total sales revenue.

Supply Management controls the largest cost elements (purchased materials and services), the longest lead-times (R&D to post delivery), and the primary usage of information technology, the first contact with suppliers and the last contact with customers. There cannot be any long-term improvements by ignoring Supply Management.

This prospectus addresses: -- What are the top recommendations for CPO to measure and improve performance in Supply Management?

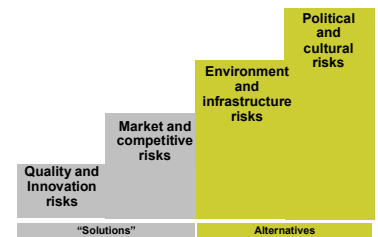
1. Identify and quantify Supplier Risk and develop Response Options.
2. Monitor how well Supply Management provides the materials and services – on time.
3. Use a market-basket approach to evaluate the competitiveness of purchase cost -- not PPV.
4. Measure the impact of suppliers on the financial chain and working capital and the validity of financial reporting.
5. Insure the effectiveness of Talent within Supply Management – training.
6. Segment the Supplier Base and measure the life cycle cost of the “*four key supply costs*”.
7. Buy on Value and Cost not Price and Discounts.
8. Benchmark the critical (important and broken) Supply Management contributions -- not just functional activities.
9. Spin-off transaction intensive and administrative costs in indirect support materials and services.
10. Most importantly, reduce Supply Management process cycle times.

The CPO can increase efficiencies and effectiveness in Supply Management without major systems investments or substantial and disruptive process changes. The top ten actions are all immediate payback on ROS – return on staff!

WHAT ARE THE TOP DOZEN PERFORMANCE INITIATIVES THAT CPOs SHOULD USE TO OPTIMIZE VALUE IN SUPPLY MANAGEMENT?

1. Identify and quantify Supplier Risk and develop Response Options.

The supplier base represents the largest controllable factor. Risks within the supplier base mirrors risks within your company, that is, the supplier base is subject to the same variables in its internal operations, regulators, competitors, and the supplier's suppliers – so is your internal operations. Changes to the suppliers' environment often dictate changes to your environment. Change is a potential risk, especially when not foreseen. Additionally, risk events are not limited to just the few major critical suppliers, disruptions from a wide range of secondary suppliers can also impact operating environment and jeopardize daily revenue.



Supplier measurement is Risk Management; it is a systematic approach to reduce risk by:

- Initially qualifying a Vendor as a Supplier to your company.
- Establishing both quantitative and qualitative measures and standards to rank and compare the Supplier against other known or potential suppliers or existing or unknown expectations.
- Specifying to the Supplier the criticality and priority of your performance and functionality requirements.
- Identifying and evaluate the functionalities offered by the supplier; their value to your company, and as the standard baseline level of performance expectation.
- Using that baseline as a starting point to measure performance improvements, new functionalities, and innovation.

Formalizing those expectations as part of the Supplier contracting and relationship management.

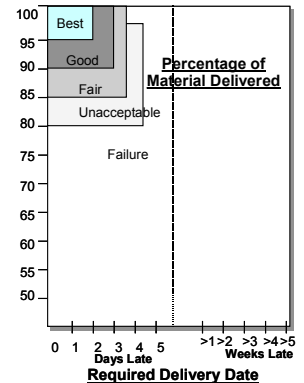
The essence of this program is Risk Management through the development of a Supplier Assessment and Measurement Profile that quantitatively and qualitatively measures capabilities and performance – both an initial baseline and continuously updated analysis. It recognizes

the need to have a well defined and realistic measurement criteria.

The first step is the development of a Supplier profile, that is the underlying infrastructure, resources, skill bases, systems, and business processes that identify how a Supplier conducts its business. That profile is crafted from two primary sources: existing research – reports, published information, analyses; and, original research, primarily of which is the data created by Supplier on-site visits and the Suppliers response to surveying questionnaires and discussions.

2. Monitor how well Supply Management provides the materials and services – on time.

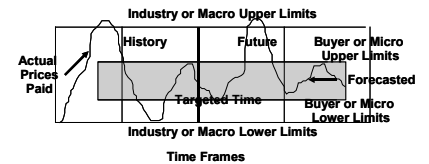
No other measure has the significance of the basic fulfillment responsibility of Supply Management. Subsequent responsibilities such as cost, quality, control, and standards, while valid, are meaningless if delivery is not accomplished. One innovative and realistic approach is a monthly graphic display of how well those goals were accomplished. The baseline is “Good” if less than 10% of total goods and service arrive late by three days. If the average is improved so that less than 5 percent arrive less than two days’ late, then the manager and supply team receive a financial bonus. If the support deteriorates so that 15 percent arrive three and a half days’ late, the manager and team receive a financial penalty. If for a continuous three-month period, the support deteriorates below 20% arriving over 5 days’ late, the manager and team have a long-term career challenge. Clearly to sign up to such a risk-and-reward performance program the rules must be rigid and the gamesmanship eliminated: for example, no requisitions would be processed where the due date is already past its due date or “dead-on-arrival”. Equally damaging is the added cost if materials are purchased early and stockpiled. Supply Management must be held accountable for managing the trade-offs. Current measurements do not effectively monitor that responsibility.



It is estimated that over 25% of all purchases by-pass the formal procurement processes. The User is sending a clear message "...either you get it on time or I will." User originated purchases compromise volume advantages and supplier controls.

3. Use a market-basket approach to evaluate the competitiveness of purchase cost -- not PPV.

Purchase Price Variance (PPV) only reconciles the overhead account. It is not a measure of performance effectiveness. Supply professionals lose credibility with savings reports that identify unrealistic cost savings while the finance department is issuing negative Purchase Price Variance reports. An effective solution is to develop a "Market Basket" concept to identify the total impact of competitive pricing. The basket consists of the Top 20 to 25 purchase commodities (materials or services) which collectively account for in excess of 80% of the total annual externally (excluding interplant and divisional purchases) purchased costs of materials and/or services. There are three categories of materials or services to be tracked: A items are the significant total dollar expenditures (unit price times volume); B items are those high single unit cost items; and, C items are neither necessary high volume or high unit cost but items critical to over-all profits and efficiencies. For each commodity and collectively for the entire basket, statistical process control charts are developed and tracked against the targeted range. The targeted range is developed quarterly by the head of supply and concurred with by the heads of finance and operations. The target range represents historical projections and engineered or benchmarked goals that recognize the estimated total usage. Quarterly reported improvements below the target areas are considered the only hard savings.



With over 50% of sales revenue expended for external purchases, nothing impacts profitability as a realistic competitive cost advantage in lowering procurement costs.

4. Measure the impact of suppliers on the financial chain and working capital and the validity of financial reporting

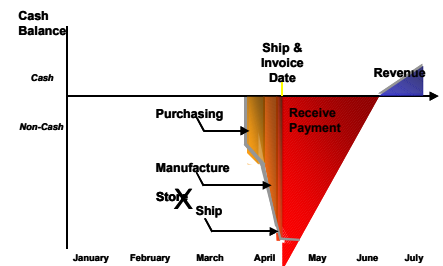
Typical billion-dollar companies today spend \$32 million annually for unnecessary working capital and inefficient processing functions, because they lack visibility into the FSC and receivables. By optimizing their FSCs, companies can:

- Reduce their working capital needs by as much as 20% to 25%, using better invoicing control and cash flow management, saving nearly \$15 million annually.
- Lower financing rates on required working capital by more than \$4 million each year.
- Gain early warning into problems with any document in a commercial transaction that will likely cause invoice payment to be delayed 30 to 45 days past the due date, then take corrective action to reconcile exceptions.
- Realize their prior investments in automating financial systems, with the savings from FSC processing equaling \$13 million.
- Eliminate expensive, non-productive float. Secure more favorable terms for the working capital based the granularity and depth of financial visibility that will allow lenders to assess the real composition and quality of receivables.

In the US, 80% of all purchase orders are still voice, fax, paper, or non-existent – resulting in orders that are in a non-standard non-digital format. Sellers must have an order entry system that is capable of receiving orders in this multi-media and multi-format environment. “...in this age of electronic commerce, where you can order in minutes and receive within hours, why does it still take months to get paid?”

In today's commerce environment 20% of all sale transactions have one or more data issues that cause reconciliation problems and delay of payment.

Over 61% of accounts receivable are over 50 days outstanding. Those with data conflicts that cannot be easily non-reconciled are over 65 days outstanding. No one knows which 20% of invoices will not be paid on time until 45 days after invoicing. Using the float of excess working capital to hedge for this internal factor is poor use of investment.



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5. Insure the effectiveness of Talent within Supply Management – impact of training.

No set of managers has the pivotal position of managing more internal and external relationships than the executives who oversee the Supply Management functions. To under invest in this human capital is foolhardy.

A major corporation (over 175,000 employees) developed a profile of personnel – based on age, years of service in current function, education, grade level, and salary. They should not have been surprised at the results. The Supply Management personnel were the oldest, longest functional service, least educated, lowest grade level, and lowest salary scale of any other functional grouping. These are the same managers negotiating prices on expenditures that measure over 50% of sales revenue, the primary users of the high investment in technology, and the last contact with customers. With such an under investment in Supply Management human capital, companies should not expect to optimize Supply Management.

Executive Management cannot afford to ignore these issues. Supply Management's success or failure directly impacts the profitability and long-term success of the enterprise.

A short-term solution is to upgrade the investment in human capital. Appoint a seasoned executive from outside Supply Management, preferably a fast-track executive, to rotate in as head of Supply Management. The CPO should institute a manager exchange program. Two to three mid-level managers in Finance and Supply Management should exchange jobs for three months. The cross-fertilization would benefit both. Additionally, the CPO should sponsor hiring two to three entry-level MBAs into a formalized Supply Management executive development programs. Each new hire would spend the first twelve months working in three or four separate divisions. Upon completion the candidate would then be employed fulltime in one of the operations. This would be a low-cost, high visibility and value effort to raise the perception and contribution of Supply Management.

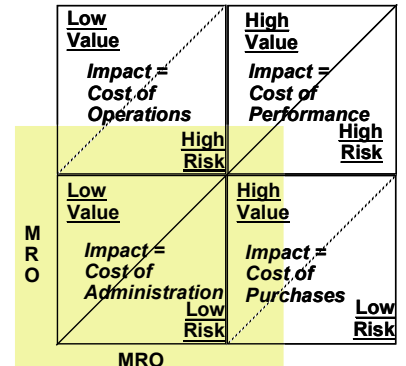


The current educational system is failing to produce qualified employees – where will your competitive talent come from?

In the future successful Enterprises will take responsibility and investment for educating employees – even in the basic skills.

6. Segment the Supplier Base and measure the life cycle cost of the “four key supply costs”

One cannot logically have a single, unified procurement strategy that is applicable across an entire supply base. It doesn't work, for example, the same procurement process shouldn't possibly apply to a \$10 wrench and a \$10,000 machine. There are basically four categories of products you purchase and they should be handled differently. “Cost” has varying degrees of impact for a commodity (cost of material); a high-tech or differentiated item such as a specialty tool (cost impact on operations); MRO (cost of acquisition); or a mission-critical input (cost of performance). For some items, and with some suppliers, you may still concentrate on volume leveraging and best prices; with others, improved service levels or collaboration in creative solutions or material design.



The quadrant approach to Strategic Partnering identifies just how important each product or service is to the firm and points to effective acquisition management for each one. It recognizes that product/service groups often need differing

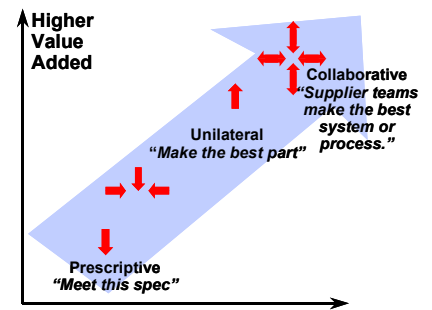
- Supply strategies,
- Tactics,
- Cost measurement, and
- Management skills.

The quadrant approach distinguishes the firm's goods and services according to 1) their value and profit potential, and 2) the risk they present to the firm. This is a departure from the traditional way of looking only at the highest dollar volume items and often ignoring the rest. Instead, the quadrant approach examines all items for their value and risk

Profit potential and value are those individual product and service features that can be traced to their use by the firm and ultimate customers, the profit they bring in the downstream channel, and their importance in maintaining a competitive advantage for the firm. **Risk** represents the chance of product failure, non-acceptance in the marketplace, faulty design and internal use in the firm, delivery failures, and source non-availability.

No competitive firm in the 21st Century can afford a Supply Management process that treats all products and services the same. The quadrant approach to Supply Management identifies just how important each product or service is to the firm and points to effective acquisition management for each one. It recognizes that product/service groups often need differing supply management strategies, tactics, cost measurement, and management skills. There are many benefits to splitting goods and services into quadrants. One, it points to distinct Supply Management approaches appropriate for different items. Two, the quadrants help align acquired items into groupings for effective management in sync with general management views of them. Three, it helps executives more effectively apply scarce resources to the appropriate area.

Companies have tens of thousands of active suppliers. It is counterproductive to establish a supplier relationship that provides the firm's key product much the same way as an office supplies purchases. Effective supply management demands a differentiated approach to the procurement process -- one that does not treat all suppliers the same. The traditional approach, with its reliance on such tactics and measures such as annual contract negotiations, supplier certifications and purchase price variances, are overkills for some suppliers and inadequate measures for others. Those tactics do not guarantee competitive advantage in pricing and support but does guarantee higher administrative costs and time delays. As many firms have recently discovered, differentiating the suppliers in the procurement processes into a differentiated set of strategies, tactics, and managerial approaches goes far in linking effective procurement to the firm's over-all corporate and product needs and competitive efforts.



7. Buy on Value and Cost not Price and Discounts.

The traditional role of a Purchasing Agent as the skilled negotiator achieving substantial price discounts has been replaced by the Supply Professional skilled in developing Value Analysis, Should Cost estimates, and Target Costing. The continued emphasis on global sourcing and outsourcing requires that the Supply Professional construct costs not just react to price lists.

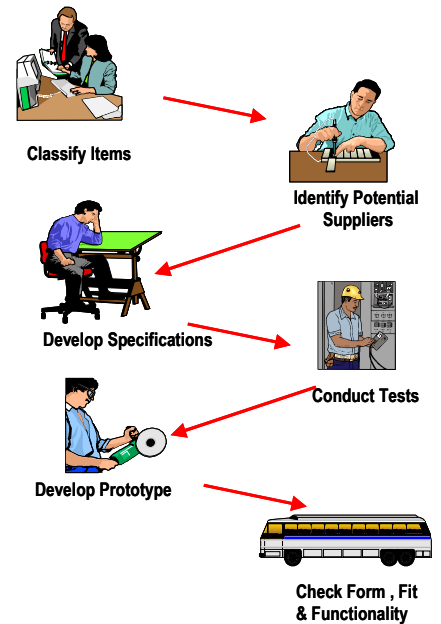
Value Analysis. Both Value Engineering (VE) and Value Analysis (VA) are tools companies are using to reduce costs by identifying unnecessary processes or costs, or improvement opportunities, in order to increase the ultimate value of the final product to the customer.

Target Costing. Target Costing is a cost management process for reducing total costs at the product planning and design stages.

Target Costing eliminates the uncertainty of the competitiveness of the selling price of the new product. When taking a target costing approach for new products, it is necessary to first determine what a competitive selling price will be for the new product, before any sub-assembly or components are designed or developed. The next step would be to obtain what targeted profit is required to continue operation of the company profitably. Subtracting the target profit margin from this competitive price leaves the target cost:

Cost and Price Analysis. For the professional buyer, it is of utmost importance to "know what you buy", and this directive is generally understood and accepted in our profession. However, when the typical buyer is asked to describe the commodity he is responsible for, or what products they purchase from suppliers, answers usually address such issues such as the technology incorporated into the purchased products and how they interface with the buyer's final product, who the major suppliers are for that component family, and supply/demand factors, to name a few. Surely, these are all very important and relevant aspects.

Total Cost of Ownership. concern is less that there is only a sole source for purchased materials but more the rationale and benefits from that procurement relationship. Sole-source relationships can improve quality, facilitate specialized services and support, and reduce over-all costs. The added cost of sole-sourced purchases is a 25% cost penalty.

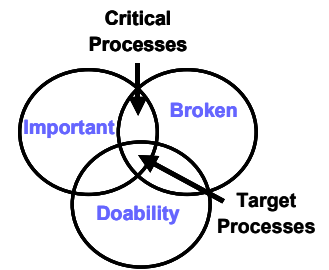


8. Benchmark the critical Supply Management contributions -- not just processes.

Identify not only the processes but also the contribution the process makes within SM: what they are, what they provide, who the end customer *is* for that process (20% of processes in most enterprises are done for no one), and how they link.

Systematically break down the processes. Look at what's actually being done versus what needs to happen; what are the gaps in "should be/ is", and what are the barriers to making the process what it needs to be?

Benchmark your critical processes consciously, formally, continuously. First, be sure you know your *own* measures. Otherwise even perfect information about competitors' or world-class companies' best practices will tell you nothing. And don't change a random process or activity just because someone else is doing it better; i.e., investing to become the best in order selection; pick-n-pack adds no value unless it gives a competitive advantage. Contrary to conventional wisdom, quality is relative -- not absolute. Focus on those processes that are critical to performing your mission.



The challenge is benchmark and invest limited resources only on those processes that are both critical and where the improvement potential is realistic and, most importantly, gives a competitive advantage.

9. Spin-off transaction intensive and administrative costs in indirect support materials and services.

This is not the mad drive to reduce the asset base or the abdication usually associated with outsourcing. There are two activities that account for over 75% of administrative costs and add little value. They are Accounts Receivable & Accounts Payable and Indirect Materials, commonly called MRO (maintenance, repairs, operating/office supplies).

For the Supply Management procurement professional, the outsourcing of MRO procurement is rapidly gaining favor with many major companies. Companies have found that 50% to 80% of Supply Management activities are MRO and must be managed differently than Production Materials.

Commonly called MRO (maintenance, repair and operating/office supplies and services), research has identified that the cost to acquire these low-value, low-risk, high-transaction items often exceeds the cost of the materials. The MRO market is less than 25% of purchased costs but over 75% of all shipments, inventoried items, accounts receivable and payable, and the transactions' processing cost.

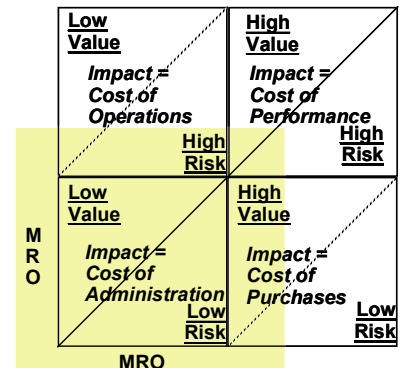
Over half of all MRO transactions account for less than 2% of total procurement at an average expenditure per transaction of less than \$50, with an average cost to acquire and administer of over \$65.

Most MRO items can be effectively outsourced. Almost 80% of MRO items can be consolidated, standardized and outsourced at both lower cost and higher service quality, while avoiding the unworkable and inflexible environment of total central management.

Companies that have consolidated, standardized, and outsourced their MRO items have realized cost savings in material, inventory and personnel ranging from 10% to 35% (as a percent of material cost).

In a survey of CPOs and Chief Supply Management Officers, from the top 1000 US companies, when asked what *NEW* function could and should be outsourced, over 70% identified the purchasing of MRO or Non-Production materials was the highest identified opportunity.

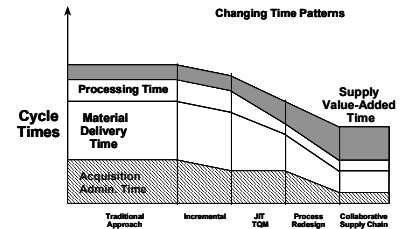
The challenge for supply management professionals is to stay out of the business of reactive, transaction processing and to become proactive players who develop strategic procurement organizations that can have a real impact on their organization's success.



No competitive firm in the 21st Century can afford a Supply Management process that treats all products and services the same. The quadrant approach to Supply Management identifies just how important each product or service is to the firm and points to effective acquisition management for each one. It recognizes that product/service groups often need differing supply management strategies, tactics, cost measurement, and management skills. There are many benefits to splitting goods and services into quadrants. One, it points to distinct Supply Management approaches appropriate for different items. Two, the quadrants help align acquired items into groupings for effective management in sync with general management views of them. Three, it helps executives more effectively apply scarce resources to the appropriate area.

10. Most importantly, reduce Supply Management process cycle times.

The basic lessons learned from JIT and Quality Control initiatives are that reductions in process cycle time exposes problems, improves resource management, and reduces over-all costs. It is blatantly unfair to burden supply management with these responsibilities, since most of the factors are beyond their control. But the longest lead times, initial and final customer contact, the largest expenditures, and the management of the supplier base are the responsibility of supply management. No other management function has the power of the supply management team to reduce cycle times. Supply management should initiate measurable programs in process time reductions, material delivery times, and acquisition cycle timeframes. Reducing process cycle time is the supremely critical success factor. It is the most important task – reduce cycle time as costs will decrease and productivity and quality increase. If you can only accomplish one effort, forget technology; just reduce process cycle time. Innovative techniques for managing time have evolved as a powerful source of competitive advantage. Companies who focus on reducing time-consuming functions in every aspect of their business often outperform their competitors.



The results are:

- Lower inventories,
- Improved responsiveness,
- Improved Quality, and
- Greater operating, efficiencies.