ZYCUS™

PROCURE PERFORMANCE

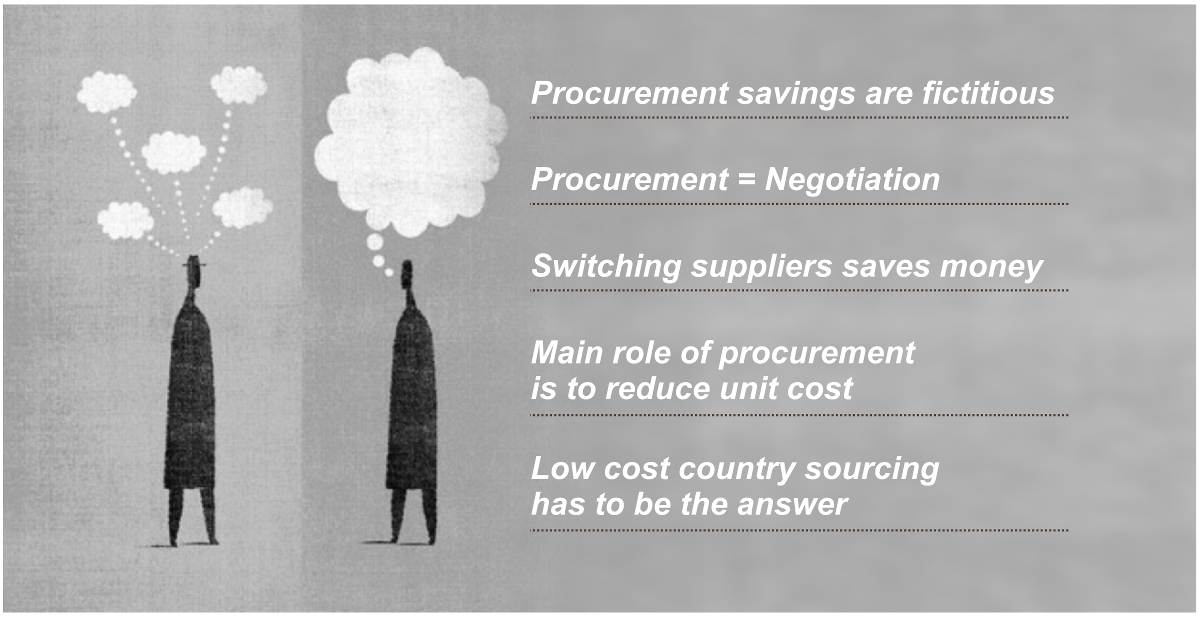
PROCUREMENT FINANCE COLLABORATION

Savings - a term which serves as a commonality between procurement & finance has also been the main reason for disputes emanating from both the functionaries. Procurement is often seen of talking about savings it generates through cost avoidance; however for finance this savings has no meaning since it does not see its impact on the bottom line. Among the many challenges that procurement and finance face, arriving at a common definition of savings tops the chart. This whitepaper provides readers with an outlook on the need for procurement and finance to unite, the challenges faced by the two in collaborating and the role of technology in bridging the gap between procurement and finance.

INSIDE THIS WHITE PAPER

Procurement and Finance
The need to unite

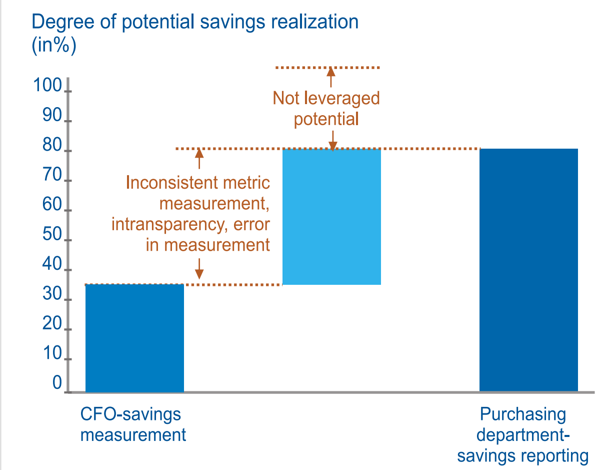
Procurement as a function within the organization is often perceived by many within the organisation with a lot of misconception especially by the 'C' level professionals.



A lot of the above misconception has to do with the processes followed within the procurement function. Savings has always been an important means of measuring the procurement performance. Savings is also a key goal for the finance function. Since savings are the common measurement criteria for both procurement and finance it also happens to be the fundamental reason of contention between the two functions. A good example of this situation is the graph in Figure 1.

This is a typical case with a number of organizations across the globe. It is seen in the adjacent figure that, there is a stark difference in the savings reported by procurement and the savings reported by finance. A lot of reasons have been attributed for the differences in the savings reported by procurement & finance. Let us consider some of these in detail.

Figure 1. Savings measurement of the CFO & diverging reporting of the purchasing department



Source: Arthur D. Little according to Aberdeen Group

Every organization has their own way of defining savings with processes varying from organization to organization. The process typically involves pulling data from multiple systems and managing the same with excel sheets. The process is not given much importance or is neglected which in turn translates into lack of collaboration between the stakeholders involved in the process. Usually multiple stakeholders are involved in the process viz. Procurement, Finance, Business groups etc. and with a lack of a collaborative platform, arriving at a consensus on critical issues especially pertaining to savings become next to impossible.

Procurement is often found speaking about savings in terms of cost avoidance which indicates the reduction in spend against the normal spend if cost avoidance exercises had not been undertaken.

Let us consider an example to have a better understanding.

Consider a manufacturer procuring wires. In the case of wire, copper being the key component, it was seen that the prices of copper increased from $4.0/LB in Jan 2010 to $4.5/LB in Jan 2011. The buyer in this case can assume at least 12-13% increase in the cost of the wires (considering nil or negligible price increase in other components like plastic). Now if the sourcing team was successful to restrict the price increase to say 10% then it amounts to a case of cost avoidance of around 2-3%.

Typically in this case procurement will speak of the savings it generated through cost avoidance but for finance professional this savings is not visible in the financial statements of the organization raising disputes between the two functionaries.

According to the Glossary of Key Purchasing terms published by National Association for Purchasing Management(NAPM), cost reduction involves the examination of existing products of services, contractual arrangements, or processes to determine potential changes that could help cut cost. A decrease from the last total price paid would be called cost reduction, and it has a direct dollar for dollar impact on the bottom line. Savings which may qualify as cost reductions include reductions resulting from: value analysis, such as substitution of a material with purchase of another, a change in source of supply, such as changing to a new supplier for the same item; a change in the character of the purchase, such as purchasing second hand, surplus, or rebuilt items, rather than new items; a change in methods of purchasing, such as adoption of blanket-order contracts; and reductions resulting from negotiations, such as an increase in a quantity discount from the supplier.

According to the glossary, cost avoidance is a purchasing action by means of which certain material or supplier increases are not incurred by the purchasing firm. It involves avoiding a future cost increase by delaying or reducing the impact of a proposed price increase. Cost avoidance does not lower the cost of materials purchased when measured against historical results. But it does minimize or avoid entirely the negative impact on net income that a price increase would have. Cost avoidance may include build-up of inventory in advance of a price increase; arrangement of unusual shipments prior to price increases; a purchase price that is lower than the original quoted price; long term contracts with price protection provisions; and resisting or delaying a supplier's price increase.

The financial impact of procurement

As the procurement organization strives to move from a cost centre to a profit centre, it is imperative that procurement starts to speak the language of finance which often looks at numbers and their impact on the company's financial statements. Before we go talk about the language of finance, let us to try to understand the area's on the company's finances that procurement can make a difference to.

The items of the income statement that Procurement can impact are mainly "Cost of Goods Sold" (COGS) and "Sales General and Administrative" (SG&A), both cost-centric influencers of "Earnings before Interest and Taxes" (EBIT)/Profit before tax (PBT). Let us understand the impact of reduction in COGS with the help of an example.

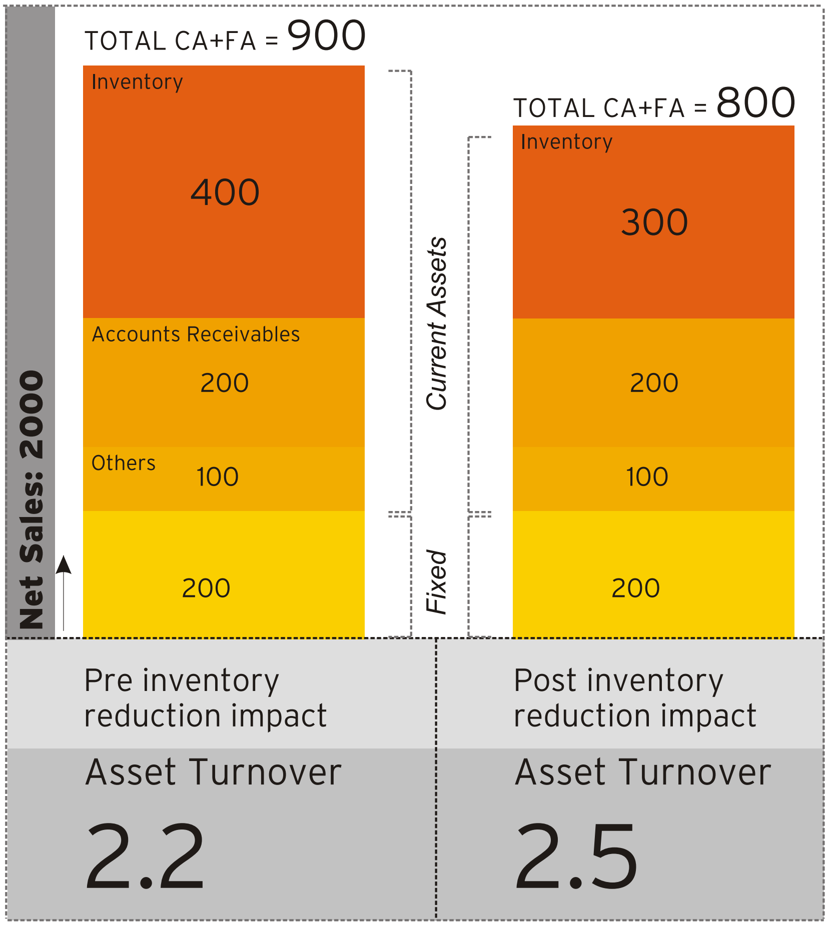
COGS for a manufacturing organizations, is typically in the range of 70-95% of revenue. Net income for these companies is typically in the range of 3-8% of revenue. Looking at a representative company who's COGS is 80% of revenue and whose net income is 5% of revenue; if you can reduce COGS by 1% (to 79.2% of revenue), that savings goes directly to the bottom line, increasing net income to 5.8% of revenue thus increasing net income by 16%.

The items to influence on the balance sheet are mainly Accounts Payable and Inventory.

Inventory plays a key role in the operations of any company especially in the manufacturing sector. Stocking inventory is a major way for companies to hedge on risks arising out of supply failures. Having said this, stocking of inventory comes at a cost (holding cost, carrying cost etc.) which has negative impacts on the company financials. Let us see how, inventory can have an impact on the balance sheet.

- High inventory increases the warehousing cost (facility, handling) the investment cost (borrowing, opportunity) and holding cost (insurance, obsolescence) directly linked to the increase of inventory. Inventory carrying costs are embedded in the general & administrative expenses resulting in a direct impact on the P&L/income statement
- Impacts the cash flow and working capital management

The case of inventory presents a challenging scenario for procurement & finance to ponder upon. In order to understand the impact of inventory reduction on the total revenue for every dollar of the asset that a company owns (Asset turnover Net Sales/Total Assets. High ratio implies better utilization of resources by the organization) let us consider the following example:



Asset Turnover = Net Sales/ Total Assets
CA = Current Assets FA= Fixed Asset

Accounts payable, also is an area of common interest to both procurement & finance. Procurement often wants the finance department to make early payments to suppliers since they consider it (rightly) as a means of building relationship. Finance on the other hand wants long credit periods which basically help them in managing the working capital. Increasing the credit period improves the cash flow for the organization, but could be detrimental in building a sustainable supplier relationship..

Supply Chain Value Drivers		Impact
Price Quantity Material cost / Inbound freight Packaging Manufacturing Conversion Cost	Sales COGS	Gross Margin
Freight/duties/fees Procurement Administration Storage & Handling Transportation (Non-Freight / Capital) Gen. Admin. / Tech Support Quality costs Returns Management Disposal Costs	Fixed /Variable	Expenses
Raw Material Inventory WIP Inventory Finished Goods Inventory Account Receivable Loading / Unloading Equipment Transportation Assets Storage Space Packaging Facilities/Equipment Manufacturing Facilities/Equipment	Current Fixed	Total Assets

The impact on COGS, Current assets etc. has a direct impact on the return on capital employed (ROCE) and return on assets (ROA). By controlling processes involving the value drivers, organizations can aim at maximizing the ROCE the best measure of profitability for organizations.

Procurement Finance collaboration
The challenges

Considering the impact of procurement on key parameters of the financial system, it is of paramount importance that procurement is able to demonstrate its contribution to the finance professionals. However, over the years, procurement has failed to demonstrate its contribution to the bottom line of organizations. In this section we will discuss some of the reasons for the lack of alignment between Finance & Procurement.

Some of the challenges faced by procurement professionals in speaking the language of finance:

- Having a common perception on the savings generated by procurement. The savings calculated by procurement are often not aligned with the accounting principles

- Project wise tracking of savings generated by procurement and impact on enterprise level savings

- Developing a reporting & monitoring system for procurement & finance professionals

- Balancing the operational continuity objectives of a Chief Procurement Officer (CPO) and working capital strategies of a Chief Financial Officer (CFO) with respect to inventory

- Setting a common goal on credit terms with the suppliers

Driving collaboration through technology

The challenges mentioned above can be addressed at a technological level and also by means of using innovative processes. This section will suggest possible ways to address the above challenges.

CHALLENGES

Procurement-Finance disconnect
Different savings definition
No common baseline for savings measurement

Lack of collaboration
No formal process for tracking, reporting and approving savings

Difficult to demonstrate **procurement's impact** on **company bottom-line**

ROLE OF TECHNOLOGY

Platform for procurement and finance professionals to set common objectives on savings, set agreed upon baseline spend and ability to track & manage savings

BENEFITS

- Enables procurement to demonstrate **financial impact** of savings
- **Single version of truth** ensures transparency into forecasted and achieved savings
- Enables finance to **forecast and book** savings into department budget and income statement
- **Track savings** across multiple parameters like business divisions, time, savings type hard/soft/avoidance /revenue share etc., strategy volume, negotiation etc., stage forecasted, realized, actual, budget down, reinvest etc.
- **Monitor performance** and take required actions in time

Technology provides a platform to both procurement & finance to arrive on the common definition of savings and set agreed upon baselines to prevent any future disputes. Once the baseline spend has been agreed upon, the next important step is to track the savings being generated enterprise wise across category and business units. It is also important to categorize the savings in terms of its impact on the bottom line. So a savings in say reduction in COGS can have impact both on the P&L and the balance sheet. However savings generated through process improvement will have its impact only on the P&L (Selling & General Administrative expense) and not the balance sheet. Tracking & Managing savings in this manner not only creates transparency and accountability among the procurement & financial professionals but it also enables procurement to forecast and report savings in the language of finance. Dynamic discounting is increasingly being used by organizations around the globe which is a major shift from the traditional view of holding payments of the suppliers to improve their (organizations) cash flow & working capital.
An interesting example cited by Peter Smith in his blog spend matters (UK) gives a lot of clarity to the concept of dynamic discounting which is as below.

Let's assume that by offering to pay invoices in 10 days instead of 30, a company negotiates an average discount across its suppliers of 2%. That's six times the interest earned by delaying payments. Furthermore, the return on capital would be 2% in 20 days, or over 36% annually.

Even if the negotiated early-settlement discount was half of the above just 1% that's an 18% annual return on capital, which is far higher than alternatives, such as delayed payment.

Having seen the example above, and in order to replicate the scenario into practicality, it is of utmost importance that organizations have a tight hold on their invoice processing system in a way where there is no information asymmetry between the procurement & accounts payable. A clean & accurate availability of supplier data goes a long way in processing invoices at a fast pace which in turn enables in realizing benefits of dynamic discounting. Reverse factoring is another innovative method of handling organizations account payable. It involves working close with one's bank to make the payment to your suppliers. What makes reverse factoring better compared to traditional factoring is, suppliers receive 100% payment against the approved invoices as against earlier when suppliers only received part payment since the factoring company were not sure about the delivery of goods/services.

Conclusion

It is essential that there exists a platform for both procurement and finance, where they can set up common agreed upon definition of savings and baseline spend which can be used as the basis of judging procurement performance. Technology provides a means for procurement to demonstrate the impact of its savings on organizations bottom line and finance can use this information obtained from procurement to monitor their performance and to forecast & book savings into department budget & income statement.

About Zycus

At Zycus we are 100% dedicated to positioning procurement at the heart of business performance. For more than a decade we have been the world's most trusted leader in Spend Analysis. With our spirit of innovation and a passion to help procurement create even greater business advantages, we have evolved our portfolio to a full suite of Procurement Performance Solutions – Spend Analysis, e-Sourcing, Contract Management, Supplier Management, and Financial Savings Management.

Behind every Zycus solution stands an organization that possesses deep, detailed procurement expertise and a sharp focus on being responsive to customers. We are a large – 600+ and growing – company with a physical presence in virtually every major region of the globe. We see each customer as a partner in innovation and no client is too small to deserve our attention.

With more than 200 solution deployments among Global 1000 clients, we search the world continually for procurement practices proven to drive competitive business performance. We incorporate these practices into easy-to-use solutions that give procurement teams the power to get moving quickly – from any point of departure – and to continue innovating and pushing business and procurement performance to new heights.

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