

## Measuring Up

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**Cost savings: there may be different ways to measure them, but it's equally important that they're recognized and validated at the executive level.**

### Points of Interest

At a glance, here are the main points covered in this article. By reading it, you will learn:

- The various ways supply managers measure cost savings
- How to ensure that cost savings are captured, measured and validated
- The importance of a strong supply-finance relationship
- How to speak the language of the CEO

It happens without fail. Every time *Inside Supply Management*<sup>®</sup> readers are queried about issues they're interested in, the resounding answer at the top of the list is "cost savings." It is obviously a critical factor by which many supply management professionals are measured. Yet, there are a myriad of things that stand in the way of a supply manager negotiating or finalizing cost savings and having those cost savings eventually hit the bottomline of the income statement. Here are just a few of the potential hurdles:

- Cost savings might be obtained on just one particular component or service element of a contract, but not on the total cost.
- A firm may lack the systems or skills to accurately pinpoint specific cost information, thereby not even being able to measure total spend or cost savings.
- Particularly for raw commodities, an inflationary market means higher prices, so the "savings" discussion becomes more a matter of "cost avoidance."
- Cost avoidance can also be measured if supply has influenced demand or use of products or services.
- Even if savings are obtained, total spend might not decrease if a business unit just uses those funds elsewhere.
- The measures that supply management is using to calculate savings might not be those recognized by the financial department.
- The time between negotiating a new contract price and actually having the final manufactured item or delivered service sell and generate profit for the company can give the perception of diluted savings.
- And finally, is the CEO interested in or getting the level of detail that shows supply management's cost-savings efforts? If the overall picture shows red, will savings efforts be recognized?

Clearly, there are many issues and parties involved. Fortunately, supply management can take steps to help ensure that cost savings are measured, validated and recognized.

## Multiple Ways to Measure

Some of the more common ways to measure cost reduction include purchase price variance of a new contract price versus a historical price, actual costs versus budgeted costs, or price reductions versus standard costs. These can be aggregated by component, product, commodity or location. From a higher view, there are measures such as cost as a percentage of total sales or supply chain cost reductions. Proactive changes in demand/usage, in order to reduce cost, is another measure, as is absolute competitive advantage — the comparison between the prices paid by your firm and by your competitors for a similar item/service. Examining purchase price versus market price leads to the discussion of cost avoidance, which is another critical measure for some. Is there a best way to measure cost savings? The answer is no, and in fact, a report from CAPS: Center for Strategic Supply Research, *Strategic Performance Measurement for Purchasing and Supply*, suggests that a combination of price/cost measures and multiple strategies are beneficial and appropriate. (For more on this report, see the sidebar below.)

The 2005 report offers these other important considerations for cost reduction measurement:

- There should be a clear set of rules defining "cost reduction."
- Cost reductions should be counted only when quantities are purchased at a new price. In other words, if promised volume yielded a lower price, the reduction is only valid if that quantity was met.
- Measures must show the relationship between actual and market price (e.g., a 5 percent savings is not valid if the market price declined by 10 percent).
- Adequate spend analysis programs (including policies and information systems) are critical for accurate measurements.
- It is advantageous to link cost reductions to specific activities (e.g., a negotiation, engineering changes, demand change, process improvements, etc.).

## Keeping Savings Intact

Regardless of which measurement methods are used, one of the biggest challenges for supply management professionals is not only "connecting" achieved savings to the bottomline, but keeping it there when other product/service factors or initiatives wreak havoc on initial cost structures. The good news is that firms are recognizing the need to monitor cost and other drivers, not only to see the results on the financials but for other indirect benefits. "Strategic cost validation is catching on," says Patrick Houston, vice president with Booz Allen Hamilton in Cleveland. "Executives are looking at planned cost savings as an enabler of growth," whether through increased margins or greater investment flexibility.

In order to accurately track costs and cost drivers, Houston suggests employing two parallel methods — budget variance analysis, managed by finance, and category dashboards, managed by procurement. The dashboards provide a high-level tracking of key cost drivers and indicators such as volume, mix and raw materials. Each of these methods supports and helps to explain the other while providing a sort of separation between church and state. Take point-of-sale materials for a marketing buy. Supply estimated key savings components, including allocations to various suppliers; it specifically consolidated requirements to focus on two standardized products to achieve savings. Later, requirements from the customer changed and some nonstandard materials were needed. If properly documented, this unrealized cost savings can be linked back to that requirement change. On the flip side, a proactive step by supply or another unit to enhance savings would also be recorded.

Houston, along with Harry Hawkes and Martha Turner of Booz Allen Hamilton, co-authored "Off the Table, into the Pocket: Driving Procurement Savings to the Bottom Line," and in that article (available online at [www.boozallen.com](http://www.boozallen.com)) gives a sample procurement savings

initiative project sheet. It's a relatively simple document that provides a framework for managing and tracking cost initiatives in a detailed way.

Terry Suelman, vice president, supply chain management for Temple-Inland in Austin, Texas, uses a similar concept. He calls it a "bridge." The pillar at one side of the bridge represents current costs. As time progresses, blocks are added to connect to the far pillar. These blocks indicate activities or decisions that affected cost. One block represents a renegotiated contract price that yielded savings. The next block details a raw commodity market with upward price pressure. The next is a business-unit decision that affected demand. Did that raise or lower the bridge (cost)? Blocks continue to create the span of the bridge until the far pillar is reached, representing the new or current cost. What you end up with is a detailed record of what drove costs, what decisions affected costs, what activities supply was responsible for, which activities supply influenced, and which were out of its control.

Having such a record can pinpoint where costs were taken out of a spend category, even if later (as is unfortunately often the case) the savings were absorbed by another activity. Mind you, there is nothing inherently wrong with a firm using money from cost-saving measures to further fund additional activities or purchases. There is no rule that says all savings must remain as profit in the bank; it will depend on organizational strategy. The danger lies in not taking the incremental steps to recognize that yes, X amount of cost savings was achieved through these actions, and then a separate decision was made to reallocate those funds.

The term is "strong-form budgeting," and it means that budgets are adjusted to incorporate changes in the savings process. "This creates a truer measure of actual versus expected spend," says Houston. He provides this example of how it works: The original budget for a project was \$1 million. After an initial assessment, it's estimated that there is money on the table and that there will be a cost savings of \$100,000; therefore, the new adjusted budget is now \$900,000. However, after rigorous sourcing and negotiations, it's believed that the final savings will instead be \$150,000.

At this point, the budget is then adjusted down to \$850,000. When the project is complete and actuals come in, they are compared to the most recent budget estimate. This way, the savings are documented, but the extra \$50,000 that was saved is not technically "available."

## **The Financial Force**

Even earlier in his career, Temple-Inland's Suelman recognized the importance of the relationship between supply management and finance. In fact, when interviewing for a position at a previous firm, he candidly asked, "How well is supply management supported by finance? Are they co-located?" The concept was foreign, but Suelman insisted on having someone within finance dedicated to supply management. This person would assist with cost analogies, the reporting structure and ensuring that savings plans were incorporated at the business level. Suelman's team would then be able to give some predictions to various business units about savings per year per commodity, for example. It was imperative that those savings became part of the financial plans — that everyone realized those savings were expected.

"We went from an environment of telling people how a particular cost savings *should* affect their financial performance, to an environment of ensuring that a savings *would* be realized and building it into the plan from the onset," says Suelman. "And we wanted finance to continue to report on the savings as an objective party, much the way it does with the company's sales figures."

The other value of having finance integrated with supply management is its ability to understand and relay how other budget developments might impact supply initiatives. For example, say the budget for a particular business unit was \$15 million and supply

management was expected to deliver a \$2 million savings. If finance had the knowledge that the budget was going to be dropped to \$10 million, that insight would be helpful to supply, as it might change the savings percentage. Perhaps the savings was based on a particular volume or product mix that won't be possible with the smaller budget. Finance is the link to the nonsupply areas of the budget that could have an impact.

Equally as important as finance on board to validate and recognize supply management cost savings is the CEO or executive management team. This is where professionals commonly hear the mantra, "speak their language." Supply management's metrics for "contract price variance" or "actual cost versus should cost" don't appear on the annual report. But translating those metrics into the language of the three primary financial statements — profit and loss, balance sheet and income statement — drives the savings home. For example, cash flow appears on the balance sheet, which can be directly affected by payment negotiation terms. "Do executives always understand our measures? No, but it's not their problem — it's our problem," says Suelman. "Just as when someone is speaking, it's the speaker's responsibility to ensure they're being heard correctly." Granted, the terms that executives do understand will vary by organization. For some, the key measurement might be "return on investment." A different firm prioritizes working capital (inventory, payables, receivables). Although the financial statements are universal, it's also critical to consider the focus of a particular company or executive.

And it sometimes can't hurt to have a flair for the dramatic. Suelman says that Temple-Inland recently got some huge savings with office supplies — \$1 million on a \$3 million spend. This, as an isolated fact, didn't quite produce the reaction one might expect. "However, when my team broke it down a bit differently, attaching some tangible examples, it had a greater impact," he says. For example, the cost of a notepad went from \$0.75 to \$0.35. He then illustrated how that seemingly small factor combines with high volume to yield an immense amount of money (and subsequently immense savings). "It was a matter of going first to the item level and playing it out a bit; telling the 'story' became a better way to communicate," says Suelman.

Another way to "speak their language," according to Houston, is to track cost for different activity levels, such as cost to market, cost to manufacture, cost to buy. With these metrics in hand, you can extrapolate a per unit total cost on a higher level and be able to state, for example, the firm's relative position on purchased goods and services as a percentage of revenue.

Of course, the ultimate value in properly acknowledging cost savings is far beyond just a matter of "who gets credit." Yes, as supply management is recognized as being a worthy contributor to the bottomline, credibility and respect build, spurring enhanced involvement in more activities and decisions. But look at the big picture. When cost savings and cost drivers are uniquely identified, as in the project sheet mentioned above, it throws open the door to examine and mitigate those drivers, look for streamlining opportunities, focus attention on risk factors, allocate resources better and even enable growth — across the entire organization and in every function. It provides a crystallized view of financial health and potential. Bringing this kind of value to total enterprise operations is what will drive significant success.

## Costs Are Not the Only Answer

No one will deny the importance of cost reductions — not only in the viability of a business but also as a critical measure for supply management performance. It's core. However, don't forget that as the function strives to contribute on the most strategic levels, expectations run high in non-cost-related areas as well. One executive procurement director has said that cost savings do not even directly figure into his area's performance. The firm is in the biotechnology field and its concentration and objectives revolve around innovation and creating growth. These core values trickle down, and while cost may be a component to achieving them, the actual measurements do not hinge on such dollars.

The cost reduction considerations mentioned at the beginning of this article are from the 2005 CAPS report, *Strategic Performance Measurement for Purchasing and Supply*. But price/cost is just one measure that the study says should be included in a strategic measurement system. The others include:

- Revenue measures
- Inventory measures
- Availability measures
- Technology, innovation and new product/process introduction measures
- Quality measures
- Workforce measures
- Operational measures
- Customer satisfaction measures

The study stresses the importance of "thinking about measures as part of a measurement system." In particular, the balanced scorecard approach is common among world-class firms. Interestingly, the details or metrics of the scorecard are not as important as the concept and process: to evaluate and measure based on several perspectives, such as customers', internal, innovation and financial. This approach, when combined with the following eight good/best practices for performance measurements, has great promise.

Good/best-practice steps for cost and other strategic measures:

1. Measures must be aligned vertically with corporate goals and horizontally with strategic business units and other functional units.
2. Measures must be comprehensive.
3. Measures must be dynamic and aggressive.
4. Measures must be transparent and communicated through the organization by both the CPO and executive leadership.
5. Measures must be closely tied to performance-based incentives.
6. Measures must be backed up with the appropriate level of organizational resources.
7. Measures must be backed with appropriate systems.
8. Measures must be championed by strong leadership.

## yoURLinks

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- [www.capsresearch.org](http://www.capsresearch.org)  
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