

Minding the Supply Savings Gaps

Accurate measurement of cost savings in the supply chain is easier said than done. But learning how to address the measurement and reporting challenges can make businesses more profitable and more competitive.

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SUPPLIERS CAN MAKE a significant contribution to any organization's success, both strategically and operationally. For most companies, the single largest cost category is the total spend with suppliers. Inevitably, supply represents a fertile area for cost improvement efforts, and most organizations expect it to deliver significant cost savings and profit improvements. However, figuring out how to identify the best areas for supply savings — and then how to measure and report them — presents major challenges.

Both understatement and overstatement of supply savings gaps signal the wrong reality, leading to an overemphasis on low-yielding cost-saving initiatives, misdirected corporate resources and rewarding employees for the wrong behavior. Perhaps even more frustrating for managers is that supply savings gaps conceal the strategic contribution suppliers can provide. Nevertheless, our research on the supply management practices at 30 large companies located in North America and Europe shows that effective measurement and reporting of savings on purchased goods and services is easier said than done. (See "About the Research," p. 26.)

Measurement and Reporting Challenges

The pursuit of savings is at the core of every supply professional's job and requires significant time and resources. At the start of any supply initiative, managers need to make a judgment call to identify the benefits they hope to achieve. Subsequently, they have to be prepared



THE LEADING QUESTION

As companies strive to wring savings from their supply chains, how should managers measure the savings?

FINDINGS

- ▶ Identifying gaps can point managers to competitive opportunities.
- ▶ Understatement of supply savings lowers the status of supply and reinforces the search for low-yielding initiatives.
- ▶ Overstatement undermines morale and rewards employees and suppliers for poor performance.



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to evaluate the actual results versus the estimates and report accordingly. We have identified six major factors that prevent organizations from accurately measuring and capturing supply savings (see Supply Savings Gaps").

1. Systems that don't account for savings. Accounting does not generally get involved in auditing for supply savings. An organization's own rules defining what does and does not qualify as a savings can be a major obstacle. Inappropriate rules drive inappropriate behavior. For example, at one company in our study, organizational pressure to meet the minimum annual savings target was so strong that buyers routinely banked savings opportunities to ensure their continued employment. The minimum was reached annually, but the maximum was never pursued.

ABOUT THE RESEARCH

Our primary research objective was to identify major supply changes occurring in large companies. Our findings are part of an exploratory study of supply management practices at 30 large global organizations with head offices in North America and Europe. We conducted two-day site visits at each company, during which we did face-to-face interviews of approximately 90 minutes each. A protocol containing approximately 70 questions was developed prior to the first site visit; adjustments to the protocol were made later to improve the clarity of questions and to streamline the interview process. Certain questions were added for each site based on an analysis of the data available prior to the visit, such as corporate and news reports. The interviews were semi-structured to allow opportunities for the interviewees to volunteer information and for the interviewers to pursue interesting and relevant lines of questioning. We interviewed a total of 201 people. Typically they included the chief supply officer, the person to whom the chief supply officer reported, the CEO, various senior executives from other functional areas and key senior supply managers who reported directly to the chief supply officer. Both researchers prepared extensive written notes from each interview. Data collection extended beyond the interview protocol to include annual reports, press releases and information about senior executives available on company Web sites. During site visits, we collected information including organization charts, management presentations and consultants' reports.

The greatest value improvement potential exists at the need definition and specification stage, when earlier supply and supplier involvement can reveal major savings opportunities. Internal cross-functional cooperation and integration is essential to find the appropriate match between internal strategic and operational needs, both short- and long-term, and what the market is able to provide.

It is difficult to imagine generating supply savings without cooperation and support from others

within the organization. The effort may involve re-designing the current supply chain, using different suppliers, substituting materials or services, process changes or other adjustments. In many cases, the analysis needs to be developed or at least supported by people outside the supply organization. This raises questions about how much credit should accrue to the supply people versus the other parties involved. Even if a supply person instigates a savings improvement, does he or she deserve the full credit?

Many supply managers look for savings opportunities that do not require the involvement of others, even if this means ignoring high-potential savings areas. An electronics company in our study had an elaborate set of rules governing reportable savings. The goal was to make sure that savings were "provable beyond any doubt" during the current year and the result of supply effort alone. However, such rules can be counterproductive. For example, if savings are limited to those achieved in the current year, why seek long-term contracts? If the only savings that count are those attributable to supply efforts, there is little or no incentive for collaboration with other departments.

To counteract this danger, one company eliminated its requirement for annual across-the-board supplier price reductions, replacing it with an incentive to encourage cross-functional cost reduction projects; such projects yielded improvements of 8% to 15% annually.

2. Changes in markets, technologies and volume. Markets change for many different reasons, presenting a host of measurement challenges since different purchases are impacted in different ways. Direct comparisons to the previous year are difficult. For example, fluctuations in crude oil prices during 2008 and 2009 have affected everything from the cost of plastic resins to transportation services.¹

Technology changes permit substitution or new design options in many products and services to achieve equal or better performance, lower costs, shorter lead times, better quality and a host of other benefits. For example, an electronics component this year might cost \$32 compared to last year's price of \$70 for the functionally equivalent component. If

this change was due to a new technological development, does this represent a supply savings?

At many companies, volume changes are normal. Indeed, one of the most common supply strategies for reducing costs is standardizing requirements to a common specification. By agreeing to purchase higher volumes from a single source or select group of suppliers, sourcing managers are usually able to negotiate substantially lower prices. For example, one large European financial services company reduced costs by 30% per year by coordinating and centralizing IT hardware and software purchases. Changes in markets, technologies and requirement volumes make savings measurement and reporting more difficult by complicating year-to-year comparisons.

3. Unwillingness to recognize cumulative savings. Supplier prices are often quoted in relation to previous price levels. If a supplier's price levels reflect annual inflationary trends, for example, it is not difficult to predict future prices. Consequently, if a purchaser is successful in *lowering* the supply price in a given year, those savings will continue out into the future, even if the inflationary price increases resume in future years. Ignoring this multiyear price reduction potential leads to an understatement of savings.

For example, the chief supply officer of a large manufacturer of agricultural equipment committed to annual supply savings of \$350 million. However, this proved to be a challenge: Some two-thirds of the company's components were carried over from year to year. Even though supply was able to negotiate lower prices on many of these items, the CEO and CFO wouldn't accept supply savings beyond one year. Significantly, the cumulative supply savings over a five-year period would have been twice what top management officially acknowledged.

4. Incomplete definition of supply savings. Switching suppliers is a common tactic for obtaining lower prices, but few companies make the effort to calculate the associated costs and risks. A lower purchase price is relatively easy to prove. However, other factors, such as the cost of the supplier switch, the additional risk, the impact on



customer satisfaction — that is, the total cost of ownership — are commonly ignored. The evidence from North American companies sourcing from Asian suppliers indicates that there's a clear trade-off. In exchange for lower prices on purchased goods, companies increase supply chain risk, carry higher inventories, pay additional transportation costs and incur longer lead times.

There are other cases where efforts to contain costs are not recognized. Consider what happened in the steel industry in 2006. In that year, the price of hot-rolled steel coils averaged \$560 per ton; in 2007, the price fluctuated from a low of \$520 per ton to a high of \$640 per ton. Then, in the first half of 2008, prices more than doubled (from \$520 per ton in December 2007 to \$1,080 per ton in June 2008).² If some buyers had locked in their 2008 price at \$600 per ton, shouldn't their avoidance of that significant increase be credited as savings? The reality is that prices for many purchases are driven by unique market conditions that do not get taken into account when comparing year-over-year cost or price savings. As a result, most companies in our study considered cost containment or cost avoidance as "soft" savings and did not recognize them. And yet, in periods of rising prices, cost avoidance can be a major contributor to corporate competitiveness.

5. Inability to convert savings into profit. Supply savings have a way of disappearing before they hit the bottom line. Budget heads are often tempted

to redirect supply savings to other uses — to pursue pet projects or other opportunities — and thereby avoid future budget decreases. In most companies, savings accrue not to the benefit of the supply group but to others in the organization, who typically feel obliged to spend the "savings" rather than report a budget surplus.

We interviewed one CEO who had received a supply savings report totaling almost \$1 billion. However, the corporate income statement for the same period showed a loss of almost \$2 billion. "Where did those savings go?" the CEO asked. In the absence of any extraordinary expenses, it was clear that not all of the reported supply savings had actually gone to the bottom line.

6. Reluctance to revisit past decisions. There is a dark side to the pursuit of supply savings, which has also haunted value analysis/engineering efforts. After a significant savings improvement has been identified, instead of rejoicing in the new-found savings opportunity or rewarding the discoverer, attention turns backward. Management asks, "How did this component get designed, produced or transported so inefficiently in the first place?" In many instances, people looking for savings opportunities are perceived as squealers who are criticizing the past decisions or practices of fellow employees, creating a negative dynamic within the organization.

Supply Savings Gaps

Given the various supply savings and reporting challenges, it's difficult to get a realistic picture of the savings potential within an organization. Whether actual supply savings are understated or overstated, however, ignoring the variance in either direction is risky and may lead to undesirable consequences that can undermine corporate performance and competitiveness. (See "Supply Savings Gaps: Practices and Consequences.")

The Problem of Understating Savings In our experience, supply savings tend to be understated more often than they are overstated. Most chief supply officers only report those savings that can be easily substantiated. At almost every organization in our study, cost savings were measured by year-

over-year price reductions, frequently referred to as "hard savings."

However, overlooking other savings, such as cost containment, limiting price increases and holding the line on inflation or market price increases, can significantly understate supply's actual contribution. What's more, ignoring the benefits of substitution and redesign and limiting purchases to items previously acquired results in smaller reported savings. For example, one company restricted its savings calculation to one-year savings on items that were identical to items purchased the previous year. The chief supply officer refused to include such other factors as cost avoidance and the results of efforts to reduce the price on new requirements, improve quality or delivery or provide assistance to other functions with supply challenges. In his view, those activities had "no credibility in the plants and businesses, and we cannot promote them across the company."

Understatement of savings lowers the status of supply in the organization, makes it more difficult to keep and attract supply talent and reinforces the search for low-yielding initiatives. It may also diminish the status of the company as a preferred customer in the eyes of suppliers because the contributions made by exceptional suppliers are not fully recognized. This affects supplier relations and supplier motivation to contribute to customer prosperity.

Understating savings shifts the emphasis from pursuing strategic opportunities to minimizing the administrative costs of running the supply function itself. In most companies, the cost of the supply function represents about 1% of total sales. Rather than focusing on ways to reduce the cost of managing supply, management should concentrate on exploiting the bigger opportunities to reduce other costs and increase profitability.

The Problem of Overstating Savings Overstatement of savings is also problematic. It occurs for a variety of reasons, the most obvious being the failure to account for the risks and costs of achieving the savings. Reporting savings without disclosing additions to the total cost of ownership conveys a false sense that the company is already achieving important gains from supply when this is not the case. By failing to recognize the true cost implications

of major supply initiatives, the company becomes burdened with higher total costs. In the long run, the company rewards behavior for efforts that increase rather than reduce its cost structure.

Reporting savings that occurred because of market price reductions, technology or volume changes without any supply initiative is also misleading. Since the organization clearly benefits from such developments, they should of course be reported—but not as supply savings. When they are, in organizations where bonuses and promotions are linked to such overstated supply savings, the result is inflated compensation and recognition.

Another common practice is to report savings but not price increases. This creates the impression that the organization's total spending with suppliers

has decreased, when it may actually have increased. One could argue that the savings were reported correctly, but the result, unfortunately, is information that is misleading or open to misinterpretation.

By overstating savings, the wrong suppliers may be defined as exceptional and the real exceptional suppliers may be ignored. Both consequences are highly undesirable from a strategic and supplier-relations perspective. Overstating supply savings can lead to a vicious cycle where the legitimacy of supply savings initiatives are questioned, members of the supply team become demoralized by a lack of recognition for their efforts and the credibility of the entire supply function is diminished. Unfortunately, the response is often to understate savings by reporting only the savings that can be

SUPPLY SAVINGS GAPS: PRACTICES AND CONSEQUENCES

By understating and overstating supply savings, companies can signal the wrong reality and hurt corporate performance and competitiveness in numerous ways.

	PRACTICES	CONSEQUENCES
Understatement Gap	<ul style="list-style-type: none"> • Use overly strict savings rules • Compare current to last year's price for identical requirements in rising market price conditions • Count captured savings only • Do not count cost containment and cost avoidance • Do not count total cost of ownership savings • Ignore decrease in risk • Report savings only annually • Ignore cumulative savings effect • Use "silo" approach to recognition of savings • Ignore volume decreases • Practice "witch hunts" • Do not recognize or reward for savings achieved 	<ul style="list-style-type: none"> • Supply contribution not fully recognized by senior management • External and internal opportunities to reduce total costs of ownership not pursued • Savings initiatives limited to readily identifiable "hard savings" • Ineffective corporate and supplier resource allocation • Low morale of supply professionals • Overstatement of actual corporate risk profile • Lower total corporate profits • Corporate and supplier strategies misdirected • Loss of preferred customer status • Adverse competitive impact
Overstatement Gap	<ul style="list-style-type: none"> • Use overly loose savings rules • Compare current to last year's price for identical requirements in falling market price conditions • Report only savings and not increases in price • Ignore increase in risk • Ignore technological impact • Count future stream of savings as current • Focus on price versus total costs of ownership • Ignore costs of changes • Ignore costs of supplier switching • Take credit for savings achieved by others • Ignore volume increases • Reward excessively for savings 	<ul style="list-style-type: none"> • Meaningful supply savings opportunities ignored • Higher corporate cost structure • Diminished credibility of supply • All reported supply savings under suspicion • Low morale of supply professionals • Understatement of corporate risk profile • Ineffective corporate and supplier resource allocation • Corporate and supplier strategies misdirected • Loss of preferred customer status • Adverse competitive impact

proven beyond question, but this only exacerbates the problem.

Maximizing Supply Savings

In order to achieve supply savings, senior managers need to overcome the measurement and reporting challenges we described above. To assist in this effort, it is important to do the following: focus on the total cost of ownership, categorize the different types of savings and hardwire savings to the budget.

Focus on the total cost of ownership. Savings initiatives should focus on the total cost of ownership. Don't call the results "supply savings." The richest opportunities for supply savings originate from cross-functional efforts and coordination. While "going it alone" can eliminate debate over how much an improvement contributed to the organization and who gets the credit, it overlooks

across the supply chain can lead to better solutions for the corporation as a whole. For a leading consumer packaged goods company, shifting supply's focus from the lowest price to the best total value allowed teams to consider trade-offs between manufacturing uptime, price and delivery consistency, inventory levels and obtaining and retaining retail shelf space. Since team members were evaluated on team results, individuals had every reason to work together. Moreover, factoring supplier and customer considerations into the equation extended the supply chain beyond the company's narrow domain.

Categorize the different types of savings. Supply savings do not lend themselves to a "one size fits all" approach because there are different types of savings that provide a distinct range of benefits. For example, savings can come from cost avoidance or year-over-year cost reductions. They

may be the result of improvements in per-piece prices, working capital, variable costs, fixed costs, capacity, quality, sales revenues and margins. Too often, however, supply executives lump everything into one bucket and proclaim, "Last year we saved the company \$50 million!"

A good starting place is to establish a reasonable set of rules inside the supply area for what constitutes a reportable savings, when and how savings are to be reported and what role savings play in the objectives and management of the supply organization. It is important to get buy-in for these rules and methods from others in the organization, and also to reach agreement on an external savings reporting system, including what, how and when savings will be reported.

Details need to be provided regarding how the savings are calculated and categorized.

A relatively simple breakdown would separate savings into four categories: market fluctuations, routine supply efforts, cross-functional initiatives and cost containment or avoidance. Price reductions related to market fluctuations typically do not require special supply effort; they need to be reported when they are significant, but the context should be clear. Routine price and total cost of

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opportunities for bigger savings.³ Supply managers must be prepared to replace their fixation with price savings and focus instead on corporate savings versus supply savings; this requires giving credit to others in the organization who contribute to major supply initiatives.

One electronics manufacturer met the challenge by establishing a process whereby a team drawn from different disciplines came together monthly to track all costs and profits associated with a particular product. The team determined prices and target costs for the period ahead, compared actual profit performance to the target and explored causes for deviations. The objective was to improve margins and to make everyone jointly responsible for product or service success. Bonuses for the team members were directly tied to meeting profit objectives.

The concept of life-cycle cost and trade-offs

ownership savings are to be expected from efforts of supply professionals in their daily work; they should fall in the 1% - 5% range annually and be reported quarterly. Supply savings from special cross-functional efforts should be reported when initiatives are completed. Lastly, savings from price increase containment or avoidance should also be tracked and reported quarterly.

Savings reports need to be shared with others in the organization, with regular progress reports on major initiatives and changes in market conditions. Where necessary, supply savings must be qualified by providing ranges: "At a minimum, we hope to save A; the maximum could be as high as B. Sales could increase to X but should reach Y." Large savings should be reported immediately in a separate individual report.

Hardwire supply savings to the budget. A

sourcing manager at one company succeeded in negotiating a 20% reduction in prices with a major airline, with an expected annual savings of approximately \$2 million in travel expenses. Although the chief supply officer highlighted this saving in his annual report to the CEO, the benefits of the new contract never showed up on the bottom line because departmental travel budgets were never adjusted. Debates about the validity of savings and how they can be used are often best settled by looking at the budgetary implications. Skeptics can be silenced if the savings claims are directly linked to budgets and spending. Four companies in our study created new financial controller positions with responsibility for validating savings and linking cost savings to business unit operating budgets.

Hardwiring supply savings in the budget does not necessarily mean dollar-for-dollar adjustments. Business unit managers can be consulted on how best to use savings and how and where to alter budgets. For example, in the airline example above, management could have decided to leave the travel budget intact on the theory that increased travel provided opportunities for additional sales. Alternatively, the savings could have been invested in other parts of the organization, such as product or service innovation. Organizations need to have a process for making such decisions.

WHEN SUPPLY SAVINGS are reported, it's useful for supply executives to have a sense of the nature and the size of possible gaps and to be able to place it in a meaningful context. Although there is a certain amount of guesswork, the chief supply officer should be able to determine with relatively little analysis whether a reported saving is realistic, whether the estimate is overstated or understated and why a gap exists. Having a grasp of the different savings categories specified above facilitates this activity. In addition, it's important for supply executives to have a system for reporting what happened to savings after they were achieved. Did they flow to the bottom line, where they could be used to provide lower prices to customers, purchase additional equipment or offset cost variances in budgets? Or were savings redirected along the way to advance strategic priorities, such as market share growth, new products or services or professional development? Without this information, it is difficult to assess the full savings impact.

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1. The price for West Texas intermediate crude oil declined from \$145.29 per barrel on July 3, 2008 to \$31.41 per barrel on December 22, 2008. On November 4, 2009, the price stood at \$80.18 per barrel. "Spot Price Graph for West Texas Intermediate Crude Oil," Bloomberg November 4, 2009.
2. "Spot Price Graph for Hot Rolled Steel Coils," Bloomberg November 4, 2009.
3. For example, after the CEO at one company decided to use return on net assets as a new measure of supply performance, the supply organization was successful in moving hundreds of millions of dollars of inventory off its balance sheet by negotiating consignment inventory agreements with major suppliers. In freeing up cash, the company was able to reduce its high debt load and stave off bankruptcy.