

Procurement Performance Measurement

What CFOs expect from measuring Procurement Success



Procurement excellence is increasingly becoming an important factor in delivering efficient operations within successful companies. On the surface, effectively measuring procurement performance is no rocket science. However looking deeper, adequate measurement of procurement success is a big issue, as bottom-up reported savings can significantly deviate from the key financial figures a CFO looks at. Arthur D. Little's latest study on procurement performance identifies the key challenges that companies currently face in developing a CFO-friendly procurement performance measurement. This report suggests a best practice approach to overcoming these challenges and consistently measuring purchasing success in the future.

Why the views of CFOs and procurement officers often differ

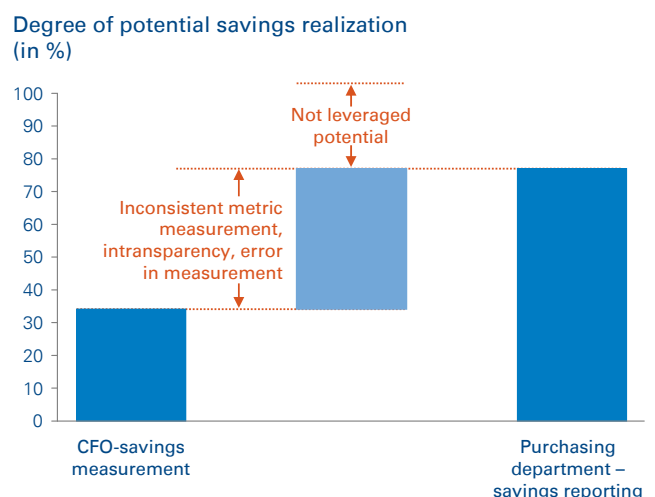
During a downturn, when companies must consider every avenue for cutting costs in order to simply survive, the procurement department plays an increasingly important role in achieving this strategic goal. A purchasing performance figure benchmarks the target achievement within the organization while functioning at the same time as a key performance indicator for the control and allocation of liquidity respectively assets.

Even if the purpose of a dedicated procurement performance is not up for discussion, its quantitative measurement remains a big issue. Practical experience shows significant divergences between performance figures reported by procurement departments and those in the CFOs' books. On average, management executives are able to analyze less than 50% of bottom-up reported savings (see figure 1). There are a variety of reasons for this:

- Different working definitions of the term 'savings'
- Missing arithmetic for measurement and aggregation of savings
- The overlap of procurement results with external effects (e. g. sales development)
- Inconsistent links between procurement strategy and the business plan
- 'Maverick buying' (purchases made without involving the procurement departments)

The study focuses on how to overcome these barriers to effectively measure a procurement department's performance. It offers companies insights into how to resolve these inconsistencies and increase their overall effectiveness by providing a properly designed generic framework for procurement performance measurement.

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



Procurement managers' key challenges¹

In a recent study Arthur D. Little investigated a series of real-world challenges currently facing procurement performance measurement. The report outlines an innovative approach to overcoming these challenges, based on a cross-industry best practice approach (see figure 2²).

Setting up a measurement framework

Based on in-depth interviews, Arthur D. Little has observed that procurement departments tend to be self-critical in regard to the current inconsistency in their measurement criteria: *"Savings calculated by procurement departments are typically not aligned with the well-known principles of adequate and orderly accounting."* This is because the financial framework chosen to analyze purchasing success is critical to its accurate measurement: *"Most purchasers still think within an 'internal' world of cost/ performance accounting according to the 'amount * price' principle. But for a CFO's controller, the effects of purchasing actions on a balance sheet and cash flow calculation are critical. Therefore the CFO doesn't care about a hypothetical calculation."* In fact, *"the*

procurement community has to learn how to speak the CFO's language" in order to bridge this gap in performance reporting. Although procurement should not be directly measured according to P&L – as it does not influence valuation decisions – the transition between different metrics must be clearly defined.

It is also quite evident that *"a savings performance indicator can only claim to be a financial metric if it also includes negative effects, e. g. taking account of increasing prices."* Against this background it is quite astonishing that sixty-three per cent of the procurement departments surveyed simply ignore their responsibility for rising purchasing costs.

Considering cost avoidance and market price development

In addition, so called 'cost avoidance' has no universal definition in the procurement world hence the term should be handled with care. Some refer to it only on initial or one-time purchases, while others also use the term to refer to rising market prices for recurring purchases.

Figure 2. Key challenges, practical examples and best practices for procurement performance measurement

Key challenges for procurement performance measurement	"Practical examples"		Possible best practice approach
Select financial framework for success evaluation	Mix of repetitive & one-time purchases & indirect/ internal benefits (TCO) 49%	Transition into P&L & cash flow/expenditures ensured together with bookkeeping 37%	Define one KPI according to P&L & cash flow; another KPI according to internal cost/ performance accounting (TCO)
Determine key reference prices (particularly for initial and one-time procurement)	Target price/internal cost requirement 36%	Price per offer e. g. best offer of negotiation participants 26%	Budget after procurement involvement based on external market data
Consider increasing costs (i. e. rise in prices)	Generally not considered ("buyer's perspective") 63%	Considered 37%	Consider increasing costs
Include & define cost avoidance	Addition to "real" savings → ONE KPI 41%	"Real" vs. "hypothetic" savings → TWO KPI 36%	Define additional KPI: "Savings vs. market price development"
Include market price development (i. e. take into account increasing & decreasing prices)	Within the context of cost avoidance 54%		Define additional KPI: "Savings vs. market price development"
Consider effects of procurement decisions over a longer time period	Short-term one-period measurement 76%	Baseline-related for the year effects incur respectively 12%	Consider baseline-related for year incurring
Measure optimized working capital	Poured into the performance measurement via "other purchasing benefits" or "total value" savings 52%		Measure only in context of "term of payment"
Develop a capital- or value-based steering approach (i. e. EVA*)	No "capital-value-based" steering of procurement 89%		"Nice to have approach", not obligatory
Measure the success of decentralized departments	Consistent performance measurement system with individual types of targets 96%		Measure consistently with individual types of targets
Consider the influence of the budgeting process on performance measurement	No participation of procurement, budget is the baseline for initial/one-time purchasing 36%	Procurement integrated in cost center planning, budget targeting measurement 17%	Integrate procurement into the budget process with cancellation of budget baseline

* EVA = Economic Value Added

Source: Arthur D. Little's 2009 Purchasing Value Excellence Study and expert interviews with a cross-industry selection of European multinational companies; percentages indicate the portion of companies that agree with the respective statement

1 Quotes are taken from selective interviews with experienced procurement executives across all industries
 2 Percentages give the share of interviewed companies that follow the named approach

Forty-one per cent of procurement departments only use one figure to represent both the nominal 'cash' savings compared to the expenditures of the previous year, as well as the 'real' performance measured on market price level. In Arthur D. Little's survey, this proved to be a popular issue facing procurement managers. For instance: *"General consideration of market price development in the context of procurement performance measurement is a very fair method to evaluate a purchaser's output."* However, both cash savings and market price-based analyses should be stringently represented with separate performance figures in order to avoid a mixture of 'real' performance, and 'cash' savings respective 'cost cutting' effects.

The budgeting process and value-based controlling

The study revealed that until procurement departments address and overcome the basic challenges outlined above, their measurement will not meet further expectations of the CFO. For instance, eighty-nine per cent of the companies interviewed believe that value-based steering of procurement is not a critical business issue of the day. However, as procurement departments become increasingly involved in the budgeting process, it will become more important to consider payment terms. Seventeen per cent of the procurement departments interviewed for this study already play an active role in their organization's budget process. With this trend set to grow it will become clear that *"savings measurement with a budget baseline often leads to a so-called 'sourcing dilemma,' since procurement defines its own measuring criteria."*

Budget is only an incentive-compatible baseline if the procurement department is not involved in the budgeting process. In companies where this is not the case, the CFO should define an alternative target against which to measure success.

Recommended best practice approach for a proper performance measurement

The first and most important challenge for procurement departments and their CFOs is to design a consistent framework for financial evaluation of procurement performance. To help companies develop such a framework, it is useful to draw a model along the following three dimensions. The final model should, of course, implicitly consider the above mentioned recommendations and further key challenges as outlined in figure 2.

1. **Metric of measurement:** Which financial figures and valuation of assets are considered for measurement? (e. g. P&L respective balance sheet or cash flow calculation respective cash-based accounting or cost-/performance accounting)

2. **Period reference:** Which measuring point and reference date are used? (e. g. annual budget versus actual figures)
3. **Depth of examination:** To what extent is value creation measured in the context of purchasing? For instance, does the measurement system only consider material costs, or also follow-up costs? Where is the functional reference base for measurement? (e. g. last year's prices or budget/target prices versus actual market prices)

Different aspects of these three dimensions must be combined and target-oriented according to the specific purposes for measurement within an organization. However, all companies can increase the transparency of their procurement measurement by agreeing upon selective, generic definitions for the four different key figures used to explain the **depth of examination**:

- **'Cash savings':** Financially measurable changes in expenditure³, which are directly influenced by purchasing. Procurement departments must determine an "internal" reference price as a precondition for measuring cost reduction. *For example, reducing leasing rates for the car fleet by 10% compared to last year's rates results in a 10% cash savings.*
- **'Savings vs. market price development':** Measuring expenditure versus market price development involves determining market price as a precondition, and takes particular account of 'cost avoidance' (e. g. defense against price increases). *For example, since the market price index of car leasing rates shows a 15% decrease compared to last year, our 10% 'cash saving' is not more than a -5% negative 'saving vs. market price development'.*
- **'Total value savings':** Change in direct and indirect costs (TCO/TVO⁴ approach) caused by purchasing; this also includes follow-up costs (e. g. for storage), as well as the evaluation of process efficiencies and changing risk positions (e. g. consequences of supplier's shortfall). This figure is calculated in addition to 'cash savings'. *For example, since our new leasing rates include administration benefits, we reduce internal administration costs by 5% relative to leasing rates, which means 'total value savings' of 15% compared to last year.*
- **'Contribution to return on capital':** Measuring procurement's contribution to return on capital includes changes in capital costs, and comprises all contributions of purchasing to changing deployed or fixed capital. Savings are therefore also set relative to used capital. This figure is calculated in addition to 'total value savings'. *Example: The new fleet leasing contract generates positive impact on capital costs through its provision of value insurance and termination options.*

³ Specifically, the terms 'payout' 'expenses,' or 'costs' are needed here

⁴ TCO: Total Cost of Ownership; TVO: Total Value of Ownership

The suggested framework and best practice examples outlined above provide an important understanding of consistent performance measurement. The general framework should serve as a guide to companies, and can be customized to meet their specific needs.

Arthur D. Little's insight

The above-mentioned core characteristics of an innovative procurement performance measurement have been identified by combining results from Arthur D. Little's ongoing Purchasing Value Excellence⁵ study with findings from selected expert interviews. The interviews with decision makers in more than ten different industries elicited up-to-date, practical examples, and illustrated some misconceptions concerning current performance measurement practices. By naming the key measurement challenges facing today's procurement departments, this report provides a framework to outline current procedures and identify future best practice.

Conclusion – how CFOs measure the future

As mentioned above, any CFO-friendly performance measurement system will clearly differentiate between the popular terms 'cost reduction', 'cost avoidance', 'total cost of ownership', and 'optimization of net present value'. By designing a clear measurement framework that takes into account consistent metrics, time frames, and levels of examination, procurement departments and CFOs can achieve transparent performance measurement from the start. With a consistent measurement system in place, it is possible for businesses to understand the true value of their target-oriented cost reductions, based on more well-defined and customized savings figures. Arthur D. Little helps its clients to customize this framework to the specific needs and requirements to suit organizational structures and reporting processes.

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Arthur D. Little

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⁵ PVE: Procurement Value Excellence, compare www.adl.com/OperationalPerformanceExcellence