Capturing procurement savings

Off the table, into the pocket
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Editor’s Note: This report has been adapted from “Off the Table, Into the Pocket: Capturing Procurement Savings,” published in Sourcing Reloaded: Targeting Procurement’s New Strategic Agenda (Strategy&, 2008).
In the wake of the Great Recession, and in the midst of the slow recovery, companies continue to turn to their procurement function as a source for additional savings. Yet for a variety of reasons — overestimating, dubious budgeting, poor demand management and compliance, and changes in baseline assumptions — the identified savings are never actually captured and reflected on the bottom line. To get the most from procurement savings initiatives, organizations need to have in place six elements. Three of these elements — initiative definition, “strong-form” budgeting, and well-defined measurement and tracking — are tactical, business process challenges. The other three — senior management commitment, cross-functional engagement, and the brokering process — are “softer” issues, but they are no less critical to maximizing savings and making changes stick.
The procurement savings conundrum

If your company is striving to capture procurement savings, you’ve no doubt heard complaints like these:

*My head of procurement is claiming €250 million in savings a year. I’ve asked him why I cannot see this in the profitability of the divisions. He says he doesn’t know. He assumes the divisions are compromising his savings with spending increases and unauthorized “maverick buys” from local suppliers.*

— CEO, global logistics provider

*We made significant strides in reducing our costs for procured marketing materials and services — reaching up to 50 percent in cost reductions in some cases and achieving an almost 10-fold increase versus our target. Unfortunately, we had no mechanism to affect the already established budget, so all the incremental savings were quickly spent.*

— Head of purchasing, North American consumer products company

In this frugal business environment, many companies are refocusing their purchasing efforts to be as thrifty as possible. Yet, as the quotes above demonstrate, it is very common to find big gaps between planned savings, actual savings on the table, and actual savings in pocket and applied to the bottom line. Despite their best intentions, too many companies discover that a large proportion of the savings their procurement executives promise seems to leak away. In fact, our experience indicates that most companies realize no more than 50 percent of the procurement savings they plan for. Others see an even more dire situation: According to a 2008 report by the Center for Advanced Purchasing Studies, even though 46 percent of U.S. corporations’ revenue is earmarked for the purchase of goods and services, and corporate procurement departments manage more than 80 percent of those expenditures, the typical corporate-wide savings program is able to realize cost savings of only 4 percent. Moreover,

Too many companies discover that a large proportion of the savings their procurement executives promise seems to leak away.
one-third of those savings represent cost avoidance, which never drops to the bottom line.

Clearly, the impact from savings leakage in procurement efforts can be significant — so significant that finding a way to plug the holes and minimize the leakage is just as important as identifying and capturing procurement savings in the first place. The good news is that the problem of leakage can be fixed. The fix takes a number of cues from the way leading companies approach cross-functional cost reduction initiatives; they achieve success by using a set of explicit execution, decision-making, and tracking mechanisms. Without such structural rigor, no focused savings program — whether a one-off savings initiative or an ongoing procurement effort — will fully produce its intended results.
Why leakage occurs

Essentially, leakage is the result of four factors (the first three are closely related to a lack of buy-in between procurement and the affected functions or divisions):

1. Overestimating

Too often, the assumptions used to project procurement savings are simply too optimistic or too aggressive. Such assumptions typically arise because of poor benchmarks, an incomplete understanding of current and forecasted spending, or misconceptions about the cost drivers that affect savings, such as supplier economics. Ultimately, these problems result from a lack of rigor and departmental input into the underlying assumptions.

2. Dubious budgeting

Once a particular department determines its expected savings, those expectations may be intentionally watered down when they are incorporated into departmental budgets — the goal being to provide a budgetary cushion to make sure budgeting expectations are met. Again, lack of organizational buy-in typically leads to this behavior. The result: The full amount of the expected savings never appears.

A corollary to this tactic involves the lack of a mechanism for capturing the additional savings created if the savings initiative exceeds expectations. In this case, the exact target savings are achieved, but any additional savings — which were not budgeted for — are simply spent elsewhere.

3. Poor demand management and compliance

Savings evaporate when companies start buying products from vendors other than those identified by the procurement process. So, for example,
instead of a 20 x 20 inch poster in black and white, marketing may purchase a 31.5 x 43 inch full-color, embossed poster from a vendor that does not have the best negotiated prices and isn’t on the approved list. Unless these “off-plan” decisions are made with a clear picture of the business trade-offs and the impact on targeted savings, functional and divisional budget owners may seek solutions that are less than optimal for the company as a whole.

4. Changes in baseline assumptions

Despite the best intentions, the effect of inflationary pressures can be impossible to avoid; for example, when increases in raw material costs and wage rates generate higher prices for vendors, the increases are often passed along to companies. To further complicate matters, a company may change what it is buying and from whom it buys. In either case, it is critical to have a well-documented baseline that enables the company to explain the impact of such shifts and account for them in the calculation of procurement savings.
Six elements must be in place for an organization to minimize leakage and maximize the delivery of savings from procurement programs to the bottom line. Three of these elements — initiative definition, “strong-form” budgeting, and well-defined measurement and tracking — are tactical and require hard-wiring, as well as some modifications to existing processes. The other three — senior management commitment, cross-functional engagement, and the brokering process — are “softer,” company-wide elements, but they are no less critical to maximizing the savings potential and making savings stick.

“Hard” tactical challenges

The tactical, business-process challenges inherent in savings initiatives can be intractable for many companies, particularly those without a culture of intensive cost management. Here are some ways to address these critical elements:

1. Initiative definition: Transparency is necessary to ensure adequate recognition of expenditures and savings and is an important basis for internal brokering and future negotiations, whether for ongoing procurement savings efforts or as part of a one-off cost-cutting initiative. Structured tools, such as the “project sheet,” can be a huge help in making sure that the savings process is sufficiently articulated so that clear responsibilities, targets, milestones, and baseline assumptions are understood by all — including procurement, finance, and individual departments (see Exhibit 1, next page). Key activities in initiative definition include:

- Documenting who is responsible for what and defining the cross-functional teams
- Clarifying spending assumptions from which savings expectations can be explicitly measured
- Committing to a schedule, including specific milestones, for execution
### Exhibit 1

**Sample procurement savings initiative project sheet**

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Industrial supplies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project title</td>
<td>Development of preferred vendor</td>
</tr>
<tr>
<td>Savings levers</td>
<td>Spend consolidation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Milestone activity</th>
<th>Planned date of completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kickoff</td>
<td>April 1</td>
</tr>
<tr>
<td>Baseline approval</td>
<td>April 21</td>
</tr>
<tr>
<td>RFP development/issue</td>
<td>May 15</td>
</tr>
<tr>
<td>RFP analysis</td>
<td>June 7</td>
</tr>
<tr>
<td>Negotiations</td>
<td>July 15</td>
</tr>
<tr>
<td>Supplier selection</td>
<td>July 31</td>
</tr>
<tr>
<td>Savings start</td>
<td>September 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Savings summary ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target</strong></td>
</tr>
<tr>
<td>$0.6</td>
</tr>
<tr>
<td><strong>Achieved</strong></td>
</tr>
<tr>
<td><strong>Budgeted</strong></td>
</tr>
</tbody>
</table>

#### Baseline assumptions
- Baseline unit pricing from sample invoices
- Forecasted volume based on baseline volume adjusted for percentage sales forecast increase
- Scope covers all six facilities in U.S. (five plants and HQ)

#### Issues
- 30 percent response rate on RFP requiring extension of time line to allow more responses

#### Notes/comments
- Need to respond to questions submitted by RFP respondents
- Draft responses to supplier questions and get input from functional team members before sending

#### Risks
- Many products in category (paint, plastics, lubricants, etc.) are petroleum-based and therefore subject to significant price increases in the short run, potentially minimizing or eliminating “cash” savings

**Team members**
- Jay Doc (procurement), Pat Dodd (maintenance), Jane Jones (manufacturing), Pete Franklin (finance)

Source: Strategy&
• Establishing savings targets to be tracked against savings achieved

• Setting up a system in finance to monitor whether procurement’s targets for project costs and savings are being met

2. **Strong-form budgeting:** Rigorous budgeting is fundamental to the procurement savings process. As a rule, budgeted savings will guide maximum savings. If you set the budgeted amount of savings too low, you are apt to end up with this artificially reduced amount.

The budgeting process sets the commitment early on and allows for visibility into realized savings. It also provides the framework in which all departments and functions must work with procurement to achieve the targeted savings. Two additional elements are critical if the budgeting process is to be effective:

• Finance must clearly link the savings initiative to the functional/divisional budgets.

• Adjustments to the budgets must also include changes in the savings targets to create a true measure of actual versus expected spend. Thus, if savings exceed the originally budgeted amount, the plan would be adjusted accordingly. For example, if the final outcome of a rigorous RFP and negotiation process yields savings that are higher than originally estimated, this upside needs to be captured in the budget or the savings will “fall off the table.”

3. **Well-defined measurement and tracking:** Poor measurement and tracking of current spending and future savings is the bane of most procurement savings efforts. It is always difficult to isolate and “see” the savings that have actually fallen to the bottom line even when you have cross-functional teaming, a clearly documented baseline, a well-defined savings initiative, and a tightly crafted budgeting process. Savings can disappear for many reasons: some manageable, such as maverick buying or specification changes; some unmanageable, such as inflation or changes in demand. Critical to knowing you have captured the anticipated savings is creating visibility into the savings identification process and successfully managing the link between finance and procurement (see Exhibit 2, next page). There are several requirements that need to be in place for this to happen:

• The procurement function must accurately track the overall progress of the project. The project sheet used to help define the initiative can also be used for monitoring. Such a tool captures procurement’s progress and compares it with established milestones.
Exhibit 2
Savings measurement tracking

- Develop savings opportunities
- Create project sheet
- Track projects and update status (savings, timing)
- Develop and monitor metrics

Ongoing reconciliation of major variances

Procurement and function
- Procurement support services liaison
- Map savings estimates to budget

Finance
- Build savings into budget
- Track budget variance vs. expected impact

Source: Strategy&
• All budgetary adjustments must be linked to departmental budgets. This process allows for savings to be built into every budget. Adjustments are made for changes in baseline assumptions as well as for the impact of increased savings, and then are tied back to individual procurement project tracking sheets.

• Actual savings must be tracked against budgeted savings on an exception basis. Broad variances from planned savings and their subsequent effect on budgets should be highlighted; price and volume variances should be normalized as appropriate to check for true procurement impacts.

• Commodity dashboards must be monitored. Drivers of deviation from expected savings results can be explained — e.g., volume, specifications of the product mix, vendor changes from original plan and baseline — and reconciled with the exception-based tracking by finance.

“Soft” organizational challenges

No enterprise-wide savings initiative has much chance of succeeding if certain organizational issues have not been dealt with. Such issues invariably involve top management leadership, interdepartmental buy-in, and consensus on decision rights.

1. Senior management commitment: Nearly every significant purchasing initiative works across organizational and functional boundaries to drive savings within budgets that purchasing does not own. And because it is often difficult to get cooperation among diverse departments, these initiatives must have executive sponsorship at the highest level of the organization in order to manage the process through any potential organizational friction and provide the necessary incentive for change.

2. Cross-functional engagement: Similarly, because procurement itself does not own a budget and has limited decision-making authority, cross-functional engagement is a key element for success. Indeed, it is required throughout the specific savings initiative — from the early identification of potential savings (baselining, savings identification and estimation, RFP development, and negotiations) to the embedding of the expected savings in the appropriate budgets to measurement and tracking of the results.

3. Brokering process: Given the divergent views that procurement and the other functions hold about purchasing savings — for example, marketing may have a natural allergy to standard materials because
it believes they inhibit creativity, while procurement may seek to streamline the SKU portfolio to gain better leverage and economies of scale — it is critical to have a process for resolving stalemates that arise during decision making, and to arrive at the right business decisions without stumbling. Often an executive body or committee is necessary to oversee this process and establish or clarify decision rights. Decisions that require brokering come in many forms: Is the savings initiative worth pursuing? What resources should we dedicate to the effort? How much of the expected savings should we budget? Should we budget for greater savings than are likely achievable in order to provide more of an incentive to save? What should we do with excess savings: reinvest them or bring them to the bottom line?
Saving the savings

Consider the typical, yet challenging example of achieving savings in the area of marketing, specifically media buying. Let’s assume that through supplier interactions and economic analysis, procurement identifies significant savings opportunities along several fronts, including switching to a lower-cost but higher-value media buying agency and instituting specific demand-side savings opportunities, such as volume commitments, regional splits, and lower-cost designs. If you think the savings will make it to the bottom line in the absence of the six elements for minimizing leakage described in this report, think again.

First, the agendas of the marketing and procurement departments are inherently at odds, and no savings will be achieved without aligning their incentives and objectives. Therefore, step one is to secure management commitment and establish a cross-functional marketing/procurement team for the initiative.

But even though marketing is part of the project team, the department is likely to seek to minimize the savings opportunities; after all, its argument will be that any such savings will adversely affect the creative product. Here is where the brokering process comes into play: Someone needs to break the tie, either by committee or through explicit decision-making authority.

Media buying is a budget-driven spending category in which savings typically mean that you get more to spend to hit the budget, so $5 million in savings usually translates to $5 million more to spend. Therefore, unless the budget is adjusted to compensate for the money saved — unless strong-form budgeting is practiced — the savings will simply evaporate. Again, senior management brokering and cross-functional teaming will help to avoid this problem.

Then comes the argument that a changing media buying environment requires additional spending or requires that savings be allocated differently: “What was the basis of savings measurement? Well, we’re operating under different conditions now, so we can’t possibly save what we said we would.” Here is where initiative definition — including savings targets, project milestones, and baseline assumptions — must be clearly articulated. If not, prepare for slippage in both execution and the ability to measure performance.

Finally, even if all else goes well, to truly identify the savings you have captured, you need to be able to clearly measure your results against the original plans and assumptions. That’s certainly more easily said than done, but if you don’t figure out how to measure the variance, you’ll never fully understand why the savings were or were not achieved. Was it a change in the spend assumptions? Did you buy what you said you would, and from the suppliers you said you would use?
Conclusion

Getting money into your company’s pocket is just as difficult as putting money on the table — and in our experience worth just as much. No matter how skillful your procurement organization is at finding and negotiating savings, a flawed process for defining and capturing those savings can significantly hamper your ability to realize those benefits and may negate any sourcing advantages you might have negotiated.

It’s more than likely that any company that has successfully led a cross-functional cost reduction program in any area has experienced the elements required for procurement savings success. The challenge, however, lies in instituting the elements of the savings process as a matter of ongoing business practice — hard-wiring the process and changing the organizational approach.

Instituting these changes can lead to significant increases in the amount of money that makes it to the bottom line of the company. With many companies experiencing a near 50 percent leakage of savings identification and capture, even a slight improvement will translate into big benefits — benefits that justify overcoming the organization’s initial resistance to change. In the end, it’s not magic but a whole lot of process discipline and organizational buy-in that is required to move the money off the table and into your company’s pocket.
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