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MEASURING THE NON-FINANCIAL BENEFITS OF STRATEGIC SOURCING

A guide to help CPOs better demonstrate how their function adds value to the organization

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Supplier Relationship Management

It's all about savings, savings, savings! Once upon a time such a statement would have rung true for most procurement functions. But times have changed. In a post-recession and ever more volatile, fast-changing and unpredictable world, the leading companies are organized so that procurement functions are focused on securing much more than price down.

Added value, risk minimization and innovation are increasingly as, and even more, important than savings. If the organization is trying to create competitive advantage by exploiting new and unique ideas and technologies from its suppliers then, whilst price will always be a consideration, it is no longer the only show in town.

CPOs and procurement functions typically need to demonstrate their contribution and the success of their interventions within the organization and across the supply base. The problem in almost all companies, however, is how to measure and show the value of the non-financial benefits – especially in organizations that judge performance only by financial results.

THE PROBLEM WITH USING ONLY FINANCIAL AND EFFICIENCY MEASURES

Neely et al (1995) define performance measurement in organizations as "the process of quantifying both the efficiency and effectiveness of actions" whilst Dumond (1994) suggests it is necessary "to support the achievement of goals with the intent to motivate, guide and improve an individual's decision making". Performance measurement is the way firms determine on an ongoing basis that they have the capability to prevail and achieve. The concept has been around for over a century now and originated as accounting systems, mostly developed in the early 1900s, to support manufacturing products in batches (Cunningham and Fiume (2003)). Since then, measures based upon financial accounting have been the primary means by which organizations have understood and corrected performance. The shortcomings of these existing 'finance only' approaches are well documented (Kaplan and Norton (1996), Neely et al (1995), Johnson & Kaplan (1987), Dixon et al (1990)). So, for performance measurement to be effective it must consider more than financial measures.

In procurement, this presents us with a challenge. Traditionally, procurement functions have concentrated on measuring the overall contribution of the purchasing function using umbrella metrics such as price savings achieved or other efficiency-based measures (Cousins et al (2008)). Typical measures used by procurement functions include Purchase Price Variance (PPV), Price savings, Cost savings, Contribution to EBITDA, Cash retention, Return on Investment (RoI) and Cost of inventory. Whilst such measures are entirely appropriate to demonstrate added value, they are however, limited and assume the organization requires procurement to deliver only financial and efficiency benefits.

Increasingly, organizations need much more from procurement – and such measures do not reflect the full extent of a modern strategic procurement function that is helping add competitive advantage to an organization. In fact, the preoccupation with such measures may detract from more useful indications of how procurement performs (Cousins et al (2008)).

YOU ARE WHAT YOU MEASURE

There is a further problem here and, as the old adage goes, 'you are what you measure'. This suggests that if we measure something then that will in some way drive outcomes. If we measure procurement performance purely based upon financial measures, there is little incentive for those within the function to work towards anything other than price reduction. This dynamic has been seen at play in some large retailers where buyers' performance, and indeed personal bonus payments, have been linked to savings delivered; the consequence being a brutal approach to beating suppliers down on price and maximizing short term gains. Without any other balancing factors, a team driven by price down will maximize organizational profits in the short term, but may sell the family silver to do so.

PROCUREMENT PERFORMANCE IS A BUSINESS-WIDE CONCERN

Whilst procurement would typically manage suppliers and sourcing, suppliers don't typically serve the procurement function. Instead, they serve an entire business and have relationships and stakeholders across the whole firm. Other parts of the business are interested in supplier performance and so would be interested in the performance of the procurement function to manage supplier performance. Other functions tend to be less interested in financial and efficiency measures, but can be more interested in factors such as operational effectiveness, responsiveness, quality, and ability to innovate. Any arrangements to measure the contribution procurement makes to an organization cannot ignore these wider business needs as it is the complete picture of supplier performance combined with performance of the procurement function that demonstrates the effectiveness overall of the procurement function.

DEVELOPING A BALANCED APPROACH TO MEASURE FINANCIAL AND NON-FINANCIAL BENEFITS

Thus, how we measure the effectiveness of procurement drives behavior and demonstrates contribution whilst also being a business-wide concern. Today's leading procurement functions are strategic contributors to overall business success in both financial and non-financial terms. Demonstrating this requires new approaches and new thinking, but firms struggle with moving from old finance-based benefit measurement to a more balanced approach. There are, in fact, four key steps that can help here:

STEP 1 – CHANGE THE WAY THE FIRM THINKS

It may seem odd to suggest such a thing, but working to change the mindsets of those who run the enterprise represents the biggest opportunity here. If the entire business is set up and run based upon financial measures only, then thinking and behavior will be finance-based and reporting will be largely numerical.

Considering non-financial benefits is not about abandoning this, but rather complementing it with other descriptions of how specific supply base interventions are helping the business. This is nothing new and forward thinking accountants running organizations have long since looked beyond the safety of direct financial benefit to demonstrating how other forms of value contribute.

STEP 2 – QUANTIFY AS MUCH AS POSSIBLE

Most forms of benefit can be converted into a measure somehow. They may just require some interpretation and creative thinking. There are two dimensions to this. First, converting soft measures into a number. This happens the world over when, for example, a person's view or judgement is the basis for measuring something using surveys that ask us to 'strongly disagree' or otherwise convert a judgement into a number that can be processed and compared. Second, it is about linking a particular intervention or action to an overall goal or measure.

STEP 3 – SHOW HOW INTERVENTION CONTRIBUTES TO A BIGGER, MEASURABLE, GOAL

A filmmaker's success is ultimately judged by box office sales. Music labels give musicians the space to do their thing but expect to see a successful album. Pharmaceutical companies invest millions in the unknown of Research and Development but hope for the next blockbuster drug, and so on. So how does this relate back to procurement? Sadly, there is little relating it back. I don't know of too many companies where those running the business might talk of taking a risk on investing in a procurement function that they hope will unlock innovation from the supply base. Therefore, one of the most powerful things a CPO can do is demonstrate how the actions and activities of the procurement function contribute directly to the success of the organization.

STEP 4 – TELL THE STORY!

Where the benefits are non-financial, traditional scorecards and number-based reporting mechanisms often mean that anything non-quantifiable doesn't get reported. This perpetuates the problem. Instead, procurement should tell the story of how procurement intervention is contributing directly towards the achievement of key business goals. This means both attempting to turn non-financial benefits into some sort of number, eg: "This month procurement is pursuing four innovation ideas from suppliers to help develop our new product". It is also about promoting a commentary that sits alongside financial benefit reporting to tell the story and adopting a different approach to reporting that allows this. It requires procurement functions to start selling themselves and driving a managed program of communication and self-promotion, as if it were an outward-facing function. If the benefits of appointing one supplier over another provide improvements to the community and this is an organizational goal, then there is a great success story that is as powerful as any scorecard of financial performance – provided the right people get to hear about it.

SUMMARY

It is becoming increasingly important for a modern strategic procurement function to demonstrate its effectiveness robustly in terms of providing financial and non-financial benefits. This is because the way we measure the effectiveness of procurement drives behavior as well as demonstrates contribution and it is also a business-wide concern. Achieving this can seem daunting, but it is in fact quite straightforward. It is about changing the way the organization thinks, quantifying benefits as much as possible and showing how intervention contributes to wider, more measurable organizational goals. Ultimately it requires the procurement function to organize itself so it can 'tell the story' of the benefit, share success stories, and make sure the good work of procurement stays on everyone's radar. Doing this is possibly one of the most effective ways a procurement function can ensure the rest of the organization is recognizing its contribution.

Jonathan O'Brien is the CEO of the international procurement and negotiation consultancy, training and tools provider, Positive Purchasing Ltd. As a specialist management consultant with over 27 years' experience in purchasing, he has worked all over the world helping global blue-chip organizations transform their procurement capability. Jonathan is also author of a trilogy regarded by many as instrumental in defining best practice strategic procurement comprising Category Management in Purchasing, Supplier Relationship Management, and the award-winning Negotiation for Procurement Professionals, and The Buyer's Toolkit - all published by Kogan Page.

This unique insight into how companies measure the performance of their procurement functions provides the basis for this whitepaper that is designed to help CPOs better demonstrate how their function adds value to the organization.

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