

## SPEND ANALYSIS: THE FOUNDATION OF STRATEGIC COST MANAGEMENT

A slow economy with still-declining sales has spurred many businesses to find additional ways to manage both internal and external costs. While cost management can span all areas of the enterprise, price pressures from customers are causing many manufacturers to put greater pressure on their suppliers to reduce the prices charged for raw materials and other product-related supplies and services.

This certainly doesn't come as a surprise when you consider that the costs related to purchased goods and services represent 50 percent or more of the cost of sales for most manufacturing businesses. However, reduced supplier pricing is just the tip of the iceberg when it comes to cost management. What more companies need to embrace is the practice of strategic cost management, which extends beyond supplier price analysis and cut-backs to include the measurement and management of all tactical processes that support cost reduction efforts.

To achieve success in the area of strategic cost management, companies need the ability to analyze Total Cost of Ownership (TCO) by accessing and understanding spend data from internal and external sources. TCO analysis allows businesses to understand process costs, assess and manage risks, manage supply chain costs, make more informed decisions related to supplier selection, support target costing, focus on continuous improvement of key suppliers, and more. In addition, it is critical to have either dedicated, skilled personnel on board to support supplier cost analyses or a spend data management system in place that can automate the process of gathering and analyzing spend data in order to monitor price and cost trends for the benefit of key stakeholders from various functions and at various levels within the organization.

Once these abilities have been obtained, manufacturers can more easily address the larger realm of strategic sourcing by leveraging TCO and other analytics to drive a strategic sourcing plan that makes fiscal sense to all parties involved – manufacturers and suppliers alike.

### Bottom-Line Cost Savings That Can't Be Ignored

Recent studies show that the ability to produce hard cost savings that flow to the bottom line is now the primary focus of procurement organizations, which traditionally have been overlooked from a cost management perspective. Soft savings that improve efficiencies are now rarely used as justification for cost improvement programs.

For example, recent research commissioned by the Center for Advanced Purchasing Studies (CAPS) — highlighted in Figure A — shows that a general manufacturing business with \$350 million in annual revenue and \$110 million in direct goods spends could generate bottom-line cost savings far exceeding \$3 million with a good spend data management system in place. According to this research, sizable cost savings can be realized by allowing manufacturing businesses to conservatively save 5% in "unmanaged" supplier base spends and to eliminate 75% of "non-purchasing controlled" maverick buying spends.

These savings, alone, are hard to ignore - no matter what the state of our economy is.

### Supply Base Spending – How Much? On Which Products? And With Whom?

Unfortunately, though, most companies don't know how much they spend, on which products, and with which suppliers. This essential lack of good data at the commodity level makes true strategic sourcing a statistical impossibility and the identification of hidden cost opportunities virtually out of the question.

Inadequate spending analysis is a corporate epidemic that costs companies \$260 billion in missed savings. Expenditures on direct goods, specifically, often exceed 60 percent of total spend. In addition, CAPS research has found that analyzing and managing Direct Goods expenditures using traditional ad-hoc reporting methods can require the support of more than one percent of a 700-employee enterprise (or 7-8 employees typically dedicated to focusing 80% of their attention on a few suppliers only). In the end, this leaves a great deal of cost reduction opportunities uncovered.

**FIGURE A - Spend Data Management Model**

Company Data*	Electronics	Consumer Products	General MFG
Spend % of Sales	45%	43%	49%
Direct Goods % of Spend	59%	46%	64%
Direct Goods % controlled by Purchasing	99%	97%	89%
Active Suppliers per purchasing employee for Direct Goods	13	12	25
% suppliers that account for 80% of total spend	6.4%	2.8%	12.4%
Of the 80% the % that supply Direct Goods	41%	43%	43%
Purchasing employees as % of total employees	0.97%	1.02%	1.14%
Maverick spend as a % of Direct Goods spend	2.5%	0.5%	1.7%
Assumptions			
Employees	700	700	700
Revenue	\$350,000,000	\$350,000,000	\$350,000,000
Model:			
Direct Goods Spend	\$92,925,000	\$69,230,000	\$109,760,000
Purchasing employees assigned to Direct Goods Spend	7	7	8
Direct Goods Suppliers	88	86	200
80% of Direct Goods \$	\$74,340,000	\$55,384,000	\$87,808,000
# Suppliers covering 80% Direct Goods Spend	6	2	25
Remaining Suppliers #	83	83	175
Remaining Suppliers \$	\$18,585,000	\$13,846,000	\$21,952,000
Maverick Spend \$	\$2,323,125	\$346,150	\$1,865,920
% maverick Spend eliminated	75%	75%	75%
Est. maverick Spend eliminated	\$1,742,344	\$259,613	\$1,399,440
% of "unmanaged" spend saved	5%	5%	5%
Est. "unmanaged" spend saved	\$929,250	\$692,300	\$1,097,600
<b>Total Spend Saving Opportunity</b>	<b>\$2,671,594</b>	<b>\$951,913</b>	<b>\$2,497,040</b>

\*CAPS Research

*This data model includes statistics reported in the CAPS Research report titled "Strategic Cost Management in the Supply Chain: A Purchasing and Supply Management Perspective." The model reflects data related to General Manufacturing, Electronics and Consumer Goods businesses.*

## The Road to Spend Management

Often, companies begin a spend management initiative by starting a labor-intensive data-gathering project. What do we spend, with whom, why, and on whose authorization? If we have a corporate procurement system for indirect goods, how can we move toward Spend Management for direct goods? Which materials and services, once the procurement is automated, will yield the quickest results? The fastest?

These are all important questions. In terms of tactical advances, however, how smoothly your Spend Management initiative rolls out will have a great deal to do with corporate structure and culture. The entire organization must be ready to accept...and embrace...change. The accountability for cost savings and cost management needs to be widespread through all core organizations and departments within the enterprise.

That being said, purchasing professionals will require a sound spend management strategy that can drive cost reductions, decrease sourcing cycle times, and reduce assets on the balance sheet. They will need to be able to manage spending on a cross-functional basis, aggregate total supply base spends, and rationalize supplier relationships.

Without a complete understanding of total supply base spending, it is nearly impossible to create a savings plan or make sound decisions about which initiatives to pursue. With incomplete expense information, excess spending remains hidden, and companies are unable to capitalize on all available savings opportunities.

To get there, more companies are now employing spend analytics – a new breed of software applications that allow purchasing professionals to identify opportunities and target initiatives based on complete, accurate spending data. With these types of analytical applications, companies can achieve a 5% to 15% reduction in materials costs that translate into a dollar-for-dollar increase in profits. How? Because they provide the information needed to reduce purchase prices and to rationalize supplier relationships and improve the utilization of corporate contracts by decreasing (or eliminating) “maverick” buying.

### **Rationalizing Supplier Relationships**

Measuring and assessing supplier performance trends, then composing a true image of supplier relationships, is crucial to the success of a spend management strategy. Manufacturers and distributors can realize significant savings by using the suppliers that serve them best. Yet keeping score on suppliers by analyzing and managing their performance is elusive unless analytics advance their capabilities past simple cost cutting to mastery of overall supplier performance analysis.

Who in purchasing has not felt the pain of trying to weigh tradeoffs between product price and other critical supplier performance factors such as delivery or quality? Very often the purchasing pro’s job is to obtain the lowest possible prices for materials and parts. It’s how their performance is typically measured. But there’s a lot of grief to pay when a production line goes down because a supplier’s parts are either late or don’t make the quality cut.

Which factors contribute to determining optimum supplier relationships? To help determine which suppliers are strategic, purchasing professionals need the right tools so they can focus more of their time on strategic, value-added planning activities. They need to be able to answer key questions related to both direct and “hidden” supplier performance measurements:

- Which vendors have the highest / lowest returns and fill rates?
- Which suppliers deliver early / late / on time?
- Which suppliers have contributed to unneeded stock outs / inventory increases?
- Who is our top supplier in terms of contract value?
- What is our top category of spending? Is this category trending up or down?
- How often do our suppliers deliver goods at pre-negotiated rates?
- Which areas of supply base spending can be consolidated / reduced?
- How much of our spending is actually controlled via the purchasing department and goes through a reasonable competitive bidding and authorization process?

### **Traditional Roadblocks to Spend Management**

At first glance, one may think that finding the answers to these questions is easy. However, many companies have implemented division-based systems that make achieving cross-enterprise visibility a challenge. Often sourcing initiatives tackle sourcing at divisional levels because the complexity of gaining enterprise visibility is daunting. This eliminates the scale benefits that companies should realize.

It’s also no secret that purchasing and supply management professionals are less than enthralled about executing comprehensive spend management strategies because of the inability to effectively access, organize, and analyze spending data, which quite frankly can be the first step to moving into an e-procurement implementation.

Consider the biggest roadblocks...

#### ***Disparate Data***

Data is spread across multiple, disconnected systems (e.g., Accounts Payable, Enterprise Resource Planning, corporate purchasing, eProcurement systems, and electronic funds transfers). An effective spend management strategy must support the automated extraction of 100% of spending information from internal and external business systems to provide an enterprise-wide view into supply base spending.

#### ***Inaccurate Information***

Spending data is often recorded inconsistently with errors, duplicates and misspellings, leaving a large amount of unclassified, “other” spend. A spend management strategy must ensure that spend data files are accurate and complete...and based on consistent data validation, cleansing and classifications adopted by the entire enterprise.

### ***Inconsistencies in Vendor & Product Information***

Incorrect naming conventions for vendors (along with erroneous or non-defined associations between a supplier's business units or distributor channel) further corrupt the spending data pool, limiting the enterprises' visibility into true spending patterns and decreasing negotiation leverage with individual suppliers. Single products may also appear multiple times in multiple enterprise systems, purchasing systems, e-Procurement systems, etc...and be described in different ways.

A spend management strategy for addressing these discrepancies must enable automated rationalization and classification of data into a structure that meets a company's unique requirements. The structure should support the classification of products and suppliers to any industry-defined taxonomy, such as UNSPSC, as well as any proprietary schema related to the business' spending areas, business units, GL codes and geographies. Organizing and analyzing information in a purchasing-relevant format also enables businesses to better plan and execute initiatives such as strategic sourcing.

### ***Limited Analytics Capabilities***

Research has shown that more than 80% of companies still use basic spreadsheet applications or reporting tools for data analysis, limiting the breadth and sophistication of analyses that can be executed.

These types of tools do not aggregate data from multiple systems and are generally inflexible in how they capture and display information. In addition, they do not offer a repeatable process for collecting information, making it purchasing-relevant and taking into account the ever-changing dynamics of new suppliers, product designs and purchasing practices.

Identifying patterns and savings opportunities among aggregate spending data requires considerable analysis. An effective spend management strategy should support role-based analysis of spending information that can be truly acted on.

## **The Insightful Benefits of "Unlimited" Spend Analytics**

Detailed spend analysis can support more effective procurement by allowing visibility into an organization's spend profile. Insightful analysis of comprehensive spend data enables identification of categories with high fragmentation or weak leveraging of supplier base, recognition of spending patterns over time, and prioritization of sourcing categories based on spend profiles.

With insight from expense analytics into spending patterns, purchasing professionals can develop stronger relationships with both internal business units and external suppliers, making the most of each relationship. By delivering repeatable visibility into all supply base expenditures, spending analysis solutions will better equip businesses for the following tasks:

- Standardize spending measurements across the enterprise
- Improve management of total supply base spending
- Leverage purchase volumes across the enterprise
- Identify opportunities for significant cost savings and supplier rationalization
- Develop optimal supplier and commodity strategies
- Determine how category spending has changed over time - corporate-wide, by department and with specific suppliers
- Enhance budgeting and planning operations
- Enforce and monitor contract compliance
- Improve inventory management through the identification and elimination of redundant inventories
- Extend and enhance the value of e-Procurement, e-Sourcing, and other technology investments

## Uncovering Savings Opportunities ... A Specific Benefit No One Can Ignore

With spend analytics software, companies can easily identify how much was spent with individual suppliers and by whom within the organization, understand purchasing behavior, develop cost reduction plans, monitor performance on an ongoing basis and uncover significant savings opportunities. These savings opportunities, which can yield upwards of 10% that can be driven directly to the bottom line, can include:

**Reduction of Off-Contract Spending:** Companies are better enabled to create purchasing strategies with approved, contracted suppliers and eliminate practices by employees who may be purchasing products and services off-contract at a significant premium.

**Consolidation of Spends:** Businesses have an opportunity to consolidate spend for future volume discounts if different business units buy the same products and services from a wide range of suppliers.

**Leverage Supplier Rebates:** Supply chain organizations are in a better position to demand rebates on money already spent when spending levels are higher than previously thought by either buyers or suppliers.

**Better Contract Negotiations:** Spending areas that have had recent, unprecedented increases in spending, may represent contract negotiation opportunities. In addition, large spending areas in particular may present opportunities to renegotiate existing contracts.

## Maintaining an Ongoing Pulse on Spending Activities

Companies that leverage a firm analytic platform to gain visibility into supply base spending patterns gain greater control over purchasing on a permanent basis. An effective spend analytics solution will enable you to aggregate spend by commodity codes and by suppliers both on the basis of dollar and purchase transaction volumes. It must build a direct material scorecard that includes variables like purchase price, transaction cost, and inventory carrying cost - all of which must be optimized to reduce the overall manufacturing cost to support the enterprise's Strategic Cost Management initiatives. And finally, with a good handle on the supply base spend, a good measurement system and good metrics, companies can work on joint cost savings projects with their suppliers using automated scorecards to ensure a sound spend management strategy far into the future.

## Conclusion

Companies that want to win in a competitive market need a vision for future success that includes Strategic Cost Management based on a sound foundation of spending analysis through a spend data management system. Solutions for spend analysis put spend visibility in focus, giving the enterprise the ability to better identify trends, track expenditures and forecast for strategic planning. At the same time, companies gain the ability to standardize procurement processes and improve supplier connectivity and relationships. By helping to reduce process costs and maximize the value of every transaction, the benefits of spend analysis go straight to the bottom line.

## About Silvon Software

Silvon Software is a global supply chain-focused business intelligence solutions provider headquartered in Chicago with more than 1,500 customers globally. The company's Stratum™ suite of operational planning, analysis and reporting applications is designed to help companies strategically plan, analyze and manage the performance of their enterprises and supply chains. The product suite features hundreds of pre-built analytical views, KPIs and reports; forecasting and collaborative planning functionality; exception management capabilities; plus, a number of flexible information delivery options for sharing data internally and with external supply chain partners. For more information, visit [www.silvon.com](http://www.silvon.com)



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