Expense Reduction Analysts

On Target:
Getting Business Operating Cost Management Right

WHAT THE CFO AND CPO SHOULD AGREE ON (BUT DON'T ALWAYS ADDRESS)

6 Core Topics for Settings and Achieving Indirect Cost Management Goals

CONTENT

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Cost Management is typically a well-integrated part of business controlling, especially when it concerns strategic costs such as raw materials, capex, staff, etc. Surprisingly, this is sometimes different with indirect or Business Operating Costs. After all, this cute cluster of fragmented expenses still usually adds up to no less than 10 – 20% of total revenue, depending on the industry. The potential impact on the bottom line is therefore vast, but at the same time also often vastly underestimated.

We believe that if a company's cost objectives and strategies are transparent and (better) aligned between Finance and Procurement, it could unlock significant additional savings and other advantages.

So, let's talk about cost.

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Peter de Heer is a senior business manager, building on a long-standing international career with various Fortune 500 companies. He has accomplished a wide range of cross-functional business, procurement and general management assignments in several countries in Western and Eastern Europe as well as in Latin America.

Peter joined Expense Reduction Analysts in 2009 and is managing national and international projects for mid-size and large enterprises. He is focused on achieving a high degree of process and value efficiency for his clients.

If you would like to talk further on these subjects, or have specific questions regarding optimizing your non-strategic, indirect expenses and related tools and processes, feel free to contact the author.

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WHO IS ACCOUNTABLE?

Hey, it's Crowded Over Here

Both Finance and Procurement touch upon the workings of all functions throughout the organisation. They both have entangled financial responsibilities and therefore should speak each other's language and understand and respect their complementary role. Given the cascading down of a company's financial objectives, the Procurement strategy should be aligned with the CFO's long-term plan.

Now, we do not always encounter this ideal situation when entering a cost management mission with new clients, especially for non-strategic or Indirect Costs. Future expenses are often only extrapolated during the budgeting process, along with the forecasted sales numbers. Actual spend (let alone actual cost savings) is often poorly monitored and analysed, if at all. To make things worse, there is just a lack of fundamental spend visibility in many companies, implying that the true level and nature of operating expenses, is simply not available. Multiply this with the number of influencers and decision-makers on Indirect Costs (HR, IT, Manufacturing, Health & Safety...) in any type of organisation and the case for strategic integration is clear.

In recent years, achieving a company's overall financial objectives has dramatically improved by the emergence of sophisticated IT solutions, including in the purchasing domain. Once these systems are integrated and their use and added value are recognised by Finance and Procurement alike, we have at least established a good starting point for further alignment.

So far, so good. But who now owns the processes and deliverables?

Who Benefits?

Everyone knows that Operating Costs are incurred by all departments on a daily basis and are therefore often considered as 'political' (In our practice, we have even seen Trade Union representatives interfering with a board decision to limit the online office supplies catalogue). When 'left alone' for the sake of avoiding awkward discussions and conflicts, indirect expenses will remain opaque and a 'permanent opportunity for improvement'.

But there is another approach. All expenses in the Non-Strategic domain present both quantitative and qualitative aspects. This split helps determine roles and responsibilities for the many stakeholders involved. The interests of Finance executives are purely focused on total cost levels, from where obviously working capital ratios, margin improvements and other variables are derived.

On the other "qualitative" side, Procurement as a supportive entity must then translate (and also challenge) the practical needs of the end users. For instance, Human Resources should set standards on the quality and value of the total Travel experience for their employees. But the selection of specific airlines or travel agencies is not part of that. In another example, Production management can set specifications for tools. However, historical claims on cooperation with certain wholesalers should not be allowed to play a decisive role here.

The specific 'art' of procurement lies in balancing financial targets and qualitative needs.

Procurement's visible impact on financial performance

Procurement management needs to think like a CFO: profit-oriented, risk-aware, commercially-focused and aligned with the company strategy. So, when is it especially difficult for a CPO to have a strong grip on financial performance? Here are some examples.

- A lack of IT tools that make financial KPI's on spend and savings tangible.
- Playing a secondary role in periodical financial/operational planning cycles, not able to contribute to the setting of expense targets.
- No formal Procurement ownership for saving measurement and results.
- Weak integration of Procurement reporting and processes (if in place at all) into general financial structures.
- A disconnection from Finance operations in day-to-day purchasing activities.
- Weak reporting, responsibility, and operational engagement between procurement leadership and the executive team.

CAN WE SET OBJECTIVES TOGETHER?

From Corporate to Category (Cascading Targets)

To be able to judge the implementation of any strategy, it is essential to set targets in advance. Without agreeing on clear and measurable goals, no activity plan can afterwards be evaluated on its achievement levels. In purchasing, this is no different and since a large number of procurement objectives is of a financial nature, the loop with overall financial planning is again closed.

There are some core topics to align between Procurement and Finance, for everyone to be able to work within an efficient process, with all stakeholders pulling on the same side of the rope:

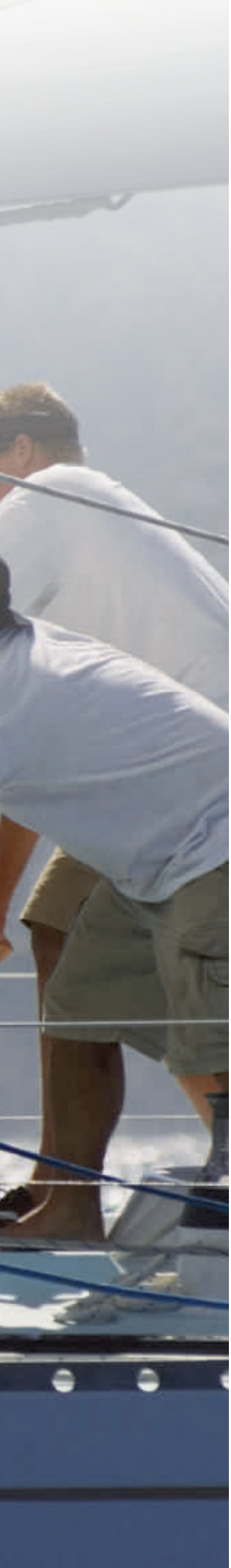
- Has the CFO defined specific indirect expense budgets to the various departments/divisions?
- Are these linked to cost reduction targets? What is their rationale? Benchmarks?
- Are these targets then operationalised with Procurement in a concrete and detailed plan of action on 'price down' vs. 'cost down' measures?
- Has the accountability question been solved? (Who is responsible for the final result?)

Obviously, agreeing on saving targets is a multi-directional process. Input from both end-users and subject matter experts (such as IT or Maintenance) is crucial for setting realistic goals and receiving team buy-in from the onset. Insufficient stakeholder acceptance will prove to be a barrier for receiving essential support and increases the likelihood of missing the set cost saving targets.

By the way, a success driver often ignored is the visible leadership commitment – including the CFO – to the entire work force. As with all strategic plans, target achievement requires reaffirming the message over and over again.

Finance KPI's that are closely linked to successful indirect procurement.

- **Competitiveness:** liberate hidden financial and time resources to reinvest in lower prices, higher quality, innovation and agility.
- **Cost of capital:** reduce working capital by reducing expenses and staff related cost.
- **Profitability:** structural margin improvement.



IS OUR SPEND VISIBLE AND MANAGED?

Is it Visible?

Obviously, before taking any stock of saving potentials within an indirect expense category, a company needs to be aware of the actual spend in that area. This sounds easier than it is and in our practice, we often discover real spend levels that were unknown to our customer. Why is that?

To have a complete overview of spend, a company needs to make sure that the following elements are well set up:

- A clear taxonomy of cost accounts and sub-accounts (transparency),
- Fully implemented in all departments, divisions and geographic locations, throughout the organisation (consistency),
- Applied to all related expenses (compliance),
- And comprehensively and correctly administrated (accuracy).

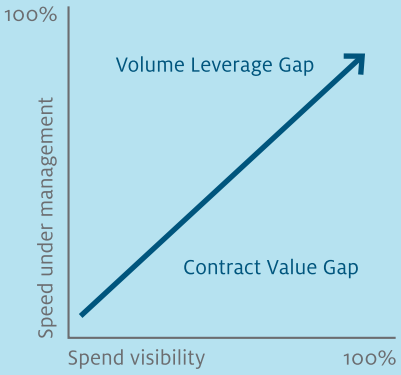
Depending on the expense category, this is more often than not a daunting task if one considers the natural rotation of vendors, staff, specifications, SKUs, etc. Therefore, a company-wide application of Purchasing Orders is an absolute minimum requirement for obtaining the basic amount of required data visibility.

But is it Also Managed?

In Procurement, an important early indicator for successful cost management is 'Spend Under Management'. Its definition depends on the maturity and ambition level of the organisation. But for this purpose, we describe it as the share of total expenses that passes through the Procurement organisation, at least administratively. Further in the experience curve then comes spend:

- being embedded in a Source-to-Pay process (negotiation)
- being embedded in a vendor contract (compliance)
- being measured and analysed by Procurement in pre-set intervals (strategy)

The higher the share of Spend Under Management, the higher the level of information, knowledge, control and thus improvement can be expected. A Spend Under Management share of 70-90 % is regarded as best-in-class. Still, many companies do not even reach a level of 30%. Clearly, without precise knowledge on expense details, there cannot be any target setting, let alone monitoring. Any arrangement between Procurement and Finance will in that case be based on flawed information.



Mind the Gaps

Obviously, the highest potential of cost reduction is reached with the best possible combination of visibility and management. This principle can be applied to overall spend or at expense category level. So, let's say that a company's visibility of its Travel expenses is high due to a good expense management tool, but poorly managed from a commercial and compliance perspective, with purchasing value being lost (Value Gap).

On the other hand, when Procurement has a perfect Contract Management process in place that is ignored by end users, part of the spend volume cannot be leveraged in full (Leverage Gap).

So, in the end, when resources are allocated to optimise cost efficiency, a choice will have to be made to either prioritise driving expense awareness by installing a Procure-to-Pay tool or establishing a complete Source-to-Pay process within an increasing number of spend categories. Experts can produce a solid RoI calculation, including benefits but also the investment in staff and IT resources and when Finance and Procurement agree on these choices in an early stage, it will allow for making even better-informed decisions.

DO WE HAVE THE RIGHT TOOLS AND PROCESSES?

P2P

So far, we have focused on improving alignment between Finance and Procurement on savings target-setting and achieving. We have shown that data harmonisation and spend visibility is a prerequisite for that. When we finally have a look at how to actually make that happen, we must examine the current sourcing processes and supporting IT tools already in place, if any at all.

The indispensable starting point of any successful cost management is a well-functioning Procure-to-Pay (P2P) process. All expenses must at least be documented (if not approved) through a Purchase Order. We know that the majority of companies already have this in place, mostly linked to the existing ERP system. But in general, there is still a significant improvement potential in terms of:

- Ensuring that the data is accurate and complete
- Working with data as a basis for both target setting, monitoring and analysis
- Preparing expense category strategies and vendor management

From Deficit to Advantage

The purchasing data complexity and volume is so overwhelming in any company, that only specialised IT solutions can help create sustainable, time-efficient and reliable conditions for successful spend control. Many cloud-based (SaaS) solutions are available on the market and we can help you select from the best.

CFO's and CPO's should jointly be revisiting their supporting IT infrastructure. In doing so, they will realise that we are only at the beginning of a dramatic transformation in operational purchasing. Accounts Payable tasks which are today carried out manually, even when supported by document digitalisation software, will become a fully automated processes. At least, within those companies that are prepared, and can afford, to invest in the latest technology. This will reduce trans action costs and boost data accuracy and real time visibility. So to look at it from a positive side, if you currently have a deficit in e-Procurement, it will be relatively easy for you to flip that into a pole position.

Our forecast on e-procurement developments that you will want to follow

- Business networks and market places will become the standard.
- AI and Robotic Process Automation will drive P2P processes.
- Analytics will offer a competitive advantage for the pro-actives.
- Procurement-as-a-Service grows as a relevant and flexible outsourcing alternative.
- Blockchain technology can become part of the Procurement infrastructure.

DO WE HAVE EFFECTIVE POLICIES?

Stick to the Rules

In our search for optimising the cost management process, we have so far mainly focused on financial and procurement-related drivers, but we should not overlook where business operating expenses originate in the organisation. Who are the 'end-users' and within which rules are they buying?

From fleet and travel expenses, to office supplies, telecommunication and factory consumables, all expenses must comply with standards set internally. These can range from 'unwritten rules' to policies formally agreed by top management. (It needs no elaboration to understand which end of this continuum offers the best cost optimisation environment.) But even when policies are in place, the CFO should not be complacent and Procurement can play an important supporting role here as an agent of change.

Within the companies that asked us to help them, we often find need for optimisation in control and compliance. Rules are not effective if not enforced by control and correction. It is good to have Policies to be embedded in company statements and explained to the users, but they should also be assigned to an owner, who both has the mandate and can be held accountable for enforcement. We always recommend to allow for no exceptions to the agreed rules. Set clear standards and

policies, as you do for your raw materials. Travel expenses are only reimbursable when booked through the company's web portal. No exceptions will be made on company car standards. Define a limited catalogue for office supplies and stick to it. Managing expectations upfront saves a lot of time and energy.

But also: do you remember when you last shared the policies with your employees? Communication and buy-in are essential for achieving saving targets.

ARE WE FACING REALITY? REPORTING ACTUAL SAVINGS.

Keep it Real

All that has been said so far is rather futile if we do not turn data into knowledge and action. Just achieving 'nice to have' is not worth the effort (nor the cost involved). Analysis is indispensable as a basis for ongoing improvement and so, we are back to the beginning of our thinking: how can Procurement become an effective and recognised partner to help achieve the company's financial targets? It is now about delivering real results.

Savings are only savings when they have a tangible and measurable effect on the bottom-line. It is the responsibility of Procurement management to ensure this happens. We advise to have the following key actions discussed in Management offices.

- Agree on base line spends and reference prices in advance.
- Only use Total Cost of Ownership (TCO). Do not ignore any relevant costs made through the ordering and consumption process.
- Don't report on identified savings only. They mean nothing. It is all about realised cost reductions.
- Make savings sustainable and continuous. Create rolling and saving plans. Fill the saving pipe line.
- Implement quarterly total spend and saving dash boards, from a category bottom-up aggregation.
- Saving milestones to be monitored and steered against in case of underachievement.
- Deviations are to be met by alternative strategies and action. In time.

The CFO will be aware that saving targets are defined for a total year. The consequence of delaying saving strategy implementation is that monthly targets will increase!

Today, the Procurement function does (or at least should) represent more than cost savings only. We agree with that principle more than anyone but Business Operating Cost reduction, being one of the most tangible contributions to corporate (financial) performance, deserves to be managed professionally and that will only happen when the CFO and CPO talk and agree on the best way forward.

AGENDA TOPICS FOR YOUR NEXT CFO/CPO MEETING.

Questions to Discuss

Ownership | Agree on who is responsible for the actual saving result.

- Are cost saving accountabilities clearly defined between ourselves?
- Is the Executive Board on the same page?

Target setting | Fit saving targets in the company's financial strategy.

- Do clear saving targets exist within our organization and are they broken down to actionable departmental clusters?
- Does Procurement have a clear role in long term sustainable saving planning?

Spend visibility | Make sure spend is on the radar and actively managed.

- Have we set targets for spend visibility and how do we make sure these are achieved in reality?
- What Category spend deserves priority to be actively managed next? How will we implement this?

Tools and processes | Create a modern infrastructure for cost management.

- Does our ERP system sufficiently support our ambitions on Indirect Cost reduction?
- Do we understand if cloud-based P2P tools could close the gap?

Policies | Set and communicate spend rules.

- Is our top 80% spend governed by clear procurement policies?
- Are these policies well documented, owned, communicated and endorsed?

Reporting | Deliver and analyse real savings.

- Do we have a robust saving reporting process in place?
- Are savings traceable in financial reporting?

ABOUT EXPENSE REDUCTION ANALYSTS

Established in 1992, Expense Reduction Analysts is a cost management consultancy focused on delivering improved business performance to clients of all sizes in both the private and public sectors. Operating in over 25 countries, Expense Reduction Analysts' 700 consultants provide deep industry expertise in a wide variety of expense categories, such as waste management, insurance, transport, marketing costs, bank charges, fleet management, telecommunications and many others.

Expense Reduction Analysts' clients include thousands of mid-sized companies and many well-known names.

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