Building an Effective Procurement Organization

Best Practices for World-Class Performance

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To all my colleagues and teams whom I was lucky to work with, gain knowledge from, and have experiences worth sharing. And to my parents—Vitaliy and Nadiia—and my friends, who always support and encourage me to follow my passions.

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INTRODUCTION

Effective spend management is one of the key challenges that any company faces. All businesses target higher profits to ensure long-term development and achievement of their strategic objectives—regardless of whether that is to create compelling new products and services or just to make the world a better place. Profits rise not only because of increased revenue but also because of accurate and professional spend management. After removing salaries, taxes, debt payments, and other obligations, a large spend line that remains is procurement.

Many pundits are quick to claim that procurement is a field where it is very hard to achieve transparency. Some companies have multilayer bureaucratic control procedures and are not always sure what tasks the procurement team is supposed to complete apart from processing contracts and invoices for purchases. Beyond this scenario, it is not uncommon that for small and midsize enterprises, a Chief Executive Officer (CEO) is the single person in the company who authorizes each and every purchase.

Leading companies build effective procurement teams that can make strategic decisions and drive business efficiency without the need to involve the genius of the CEO for every deal. They create ecosystems to collaborate with their suppliers and integrate them as their business partners while hitting impressive savings targets and creating new quality products for their clients. This is enabled not by strict procedures or centralized decision making but by the implementation of effective process designs, balanced controls, creative ideas, proper motivation, and trust.

The transformation from a middling to an elite procurement organization is within reach, and this book can help you do it. *Building an Effective Procurement Organization* explains the objectives to set for your procurement function, how to build effective procurement processes, and how to manage your spend in the most efficient way. In addition, if you represent a service or manufacturing entity and want to understand how your bigger corporate customers handle procurement decisions and operate their procurement function, this book will show you. It can provide the knowledge to build your sales strategy and make them your clients. Whether you are knee-deep in the procurement function or just interact with it, this inclusive guide will help you build better relationships and improve your procurement practice.

FOREWORD

Every year, companies spend enormous amounts of money on procurement. Statistics show that, on average, purchases may account for up to 50 percent of sales. For companies operating in the manufacturing sector, it can be even higher—rising to as much as 60 percent. Yet, only a few companies employ a systematic approach to cost management. Top executives and senior management must ask themselves two simple questions:

1. How effectively are we managing procurement spend?
2. Who do we trust to spend the company's money?

Imagine that today, a company spends 43 percent of its revenues on procurement; tomorrow, it buys the same items but from more reliable suppliers for 3 percent less. What if procurement spend was down by 5 percent? And what if by 7 percent? How would this impact company profitability? Obviously, this can make a huge difference to the bottom line.

Where do you start, and what is the first thing you need to think about if you are entrusted with procurement? What is procurement efficiency, how can it be measured, what procurement management systems exist, what are their benefits and drawbacks, and what can be generally expected from this *service* function? How do procurement systems work for large and small companies? How do you find common ground with experts in this field and with those trying to become a supplier to your company?

This book provides answers to these and other questions, as well as practical tools for managing procurement performance. It does not tell you how to negotiate effectively, it does not explain the techniques and tricks that can help you buy goods cheaper, nor does it explain how to perform cost regression analysis or calculate the margin of your supplier. Many books and articles have already been written about such things. Instead, in this book, we will talk about how to build a *procurement system* and thereby maintain a quality business service. The tools that are used to manage procurement costs may differ to some extent for large and medium-size companies. However, there are some common approaches that are relevant to all, regardless of the size of the company or its range of activities.

Procurement management practices vary from industry to industry. Procurement categories in manufacturing, for example, are different from those in the retail industry: while the former primarily purchases raw materials, goods, equipment, spare parts, and services required to support manufacturing cycles, retailers purchase goods to stock their shelves to sell to consumers. Nevertheless, the basic principles are similar in both industries. It doesn't matter to a good procurement professional whether they are buying workwear, a gas turbine, or an avocado. A true professional understands procurement in any field, regardless of category, sector, or company.

Procurement opens up opportunities beyond increasing profits. Despite this, not many companies have a professional procurement team. Why is this? The answer is simple. A procurement specialist is a recognized profession, but a higher education diploma in this field is a rarity. Furthermore, there is a lingering stigma surrounding procurement, a myth that this function in business is little more than document management—basically, an activity that does not create value and, therefore, does not require special expertise. Everyone understands which issues are handled by sales professionals, economists, financiers, lawyers, and logisticians, but not everyone can answer exactly what a procurement professional does.

I have worked in procurement for over 15 years. I became a buyer by accident, like many in the profession. At first, I was translating documents for the procurement department, then I became a buyer myself, and soon I was in charge of procurement as a Chief Procurement Officer in two power distribution companies in Ukraine that, at the time, belonged to an international energy company called AES Corporation. After a while, I took positions in the Czech Republic, Kazakhstan, and Russia. I worked with international teams that were executing large procurement projects across several countries. I started writing this book when I was in charge of procurement at Severstal, a metals and mining conglomerate in Russia with a total annual procurement spend of several billion dollars and a procurement team of around 400 people located in several cities across the country. During my early days in procurement, I was scrambling for information to understand how to manage procurement effectively and build a sustainable system in a fast-changing environment. It was difficult, sometimes very difficult. There were no obvious solutions to many issues, and not everything worked right the first time, but the challenges were all the more interesting. My teams and managers supported me, and I learned a lot from them.

This book is built around the practical aspects of procurement management that come from my own experiences and those of my fellow colleagues in different industries and companies around the world. My knowledge was developed from a variety of industries where companies buy 50,000 unique items a year, from bolts to high-tech production lines, where they maintain their own manufacturing facilities and offices, execute construction projects, manage fleets, buy special equipment, maintain railways and locomotives, etc. The stories and experiences that were shared by my fellow coworkers come from different backgrounds and are unified by a passion for building effective procurement organizations.

You should not expect to find comprehensive answers to all procurement-related questions in the pages of this book. You will not find a detailed breakdown of methodologies created by someone else. My main goal was to create a roadmap to building an efficient procurement management system. This is a good starting point for any professional in procurement or any CEO who does not have a lot of time to go into the details of procurement operations but wants to maximize the function. After reading this, if you are interested in the topic and wish to continue studying it, you will find that there is a lot of interesting and valuable information out there.

I make a special appeal to those who work in state-owned companies. After reading this book, you might question many of the suggestions I put forward. "That's impossible! My company would never support me if I tried to implement such initiatives. The author doesn't understand the specifics of state-owned enterprises." I have heard such comments many times during my presentations at conferences or while teaching at business schools. I have also worked in the regulated procurement systems of Ukraine and Kazakhstan. In my work, I sometimes encountered public procurement law requirements that appeared absurd but were difficult or impossible to circumvent. Nevertheless, everything described in this book, to one extent or another, I applied in public sector companies as well. You may not be able to implement some changes quickly and radically, but the practices described here can be applied in nearly any company. The key is to adapt them and test them in practice.

I sincerely hope that this book will help you find what you are looking for and encourage you to think about the role that procurement plays in your business. Books help in the search for ideas, but the real solutions generally come from people working together on things that matter to them and ultimately achieving results in sometimes very simple but unobvious ways. Real challenges, practices, experiences, and knowledge—mine and those of my colleagues—form the basis of this book. That is why there is a section on teamwork and motivation in procurement—after all, procurement is not just about tenders and contracts but about effective collaboration across the organization.

If you would like to share your thoughts or experiences with me about what I have written here, I would be happy to hear from you. You can reach out to me online via my *Procurement Blog by Irina Povoroznyk* on Facebook or on LinkedIn. I wish you productive reading!

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> The modern purchasing agent is a more important man by far than he was in older days when purchasing agents were likely to be more of the nature of "rubber stamps," or "buffers," or were bargainers for an extra penny of advantage. A purchasing agent of the modern breed is a creative thinker and planner and a student of many elements of business.
>
> —Helen Hysell, *The Science of Purchasing,* 1922

ACKNOWLEDGMENTS

The idea to write a book about procurement management came to me several years ago—the first lines were written in 2018. During that time, a lot has changed—new solutions, technologies, books, and research have appeared. However, the literature on procurement management that talks about the *basics*—the things that are most important to build the groundwork for a well-established procurement function—is still scarce, while the effective setup and management of procurement are more relevant than ever.

Pandemics, wars, terrorism, and environmental issues continue to test the strength of supply chains. Building an effective procurement function in which the basic processes are well organized and do not require detailed support is an expertise that is more important than ever. After all, only with robust operational processes can an organization afford a proactive, rather than reactive, model of operation and decision making in complex situations.

When I shared the idea for this book with colleagues and friends, I immediately sensed their support: some suggested topics for coverage; some helped by collecting cases and telling stories from their own practice; some took the time to read the text before the editor saw it and gave me feedback, including additions and corrections; and some invariably inspired me with their presence and the reminder that the results of this work will find an audience.

I am very grateful for the opportunity that led me into private business and procurement. During my work in this field, I met many wonderful people—real professionals—and learned a lot. Some of them later became my close friends. My experience is not just limited to procurement. Procurement covers a wide area of knowledge, but to be successful, you have to understand many things at once and find opportunities for self-improvement. My work has significantly changed me and the way I see myself. I have learned and continue to learn from my surroundings—from my colleagues, mentors, and managers; from teams in which I participated and led; from industry peers, suppliers, partners, customers, and consultants—it is impossible to list them all by name. Nevertheless, I would like to thank by name those who had a direct influence on the creation of this book:

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I also fondly remember my AES procurement team, where we studied best practices, tried to figure out how to apply them to regulated procurement, and learned, grew, and changed our procurement operations for the better. That experience was transformative for our entire team. I remember many names, but I would especially like to thank Iryna Kit, Maria Solovyova, and Olena Gavrylova—our midnight creative sessions and search for meaning occupy a special place in my memories of that time.

Friends, thank you for your support, trust, ideas, and criticism; for our team results and inspiration; and for the fact that it was with you that we checked what and how procurement actually works. It's hard to list the names of all the people who have influenced me as a buyer and a leader—there are so many great people. Even though a lot has changed over that time, including our roles, company names, locations, and even countries of residence, you will always be my dream team!

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Thank you to the publishing team for believing in this book and dedicating time to make it accessible to the wider public.

Thank you to my peers, the large professional community of procurement specialists and supply chain management professionals, consultants, experts, and readers for your questions, ideas, speeches, useful texts, information, and experiences that I have found so inspiring!

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Thank you to my friends in many different cities and countries. I have made friends through my work and studies in many different locations, and I am glad to have people in my life with whom I can maintain warm relationships despite the distance and these most difficult times we are experiencing.

Thank you to all those who have read these pages and for taking the time to read to the end. I hope you never lose your inspiration; look for it and find it in yourself and in each other. Do not rest on your achievements, but continue searching, researching, and experimenting. It is what keeps life interesting!

ABOUT THE AUTHOR

Iryna Povoroznyk is an expert in strategic sourcing and procurement, operations management, digital platforms, ERP implementation, change management, and strategic organizational transformation. For the past 15 years, Iryna has managed the procurement of one of the largest companies in the metals and mining and energy sectors. She has a proven track record of building highly motivated teams and implementing successful large-scale transformation projects that are considered a best-practice benchmark by industry peers.

A frequent guest speaker at industry events, Iryna has developed procurement education courses for both the public and private sectors in Eastern Europe and lectured on the subjects of procurement transformation, procurement/supply chain efficiency, planning, IT/ERP systems, and digital applications in the supply chain. Iryna has implemented procurement initiatives in 10 countries during her career—exposing her to diverse cultures and business practices in Asia, Europe, the Middle East, and the Americas.

Following discussions with industry peers, colleagues, and students, Iryna wrote this book for anyone who wants to build an effective procurement function within their business and better understand procurement management concepts. She hopes the reader will develop a solid base for the implementation of advanced concepts that will work not only in theory but in practice.

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Downloads for *Building an Effective Procurement Organization* include selected tables and a template for procurement function strategy development.

CHAPTER 1

PROCUREMENT SPEND: HOW MUCH IS NOT A LOT?

ASSESSING THE SCALE: WHERE TO START

Corporate shopping is not much different from your everyday shopping in a supermarket. You can be driven by immediate decisions, buy the same things out of habit, have a prearranged shopping list for a family vacation, or grab a product without reading the labels because you just want to try something new.

Imagine that you have $100, and you go to the store to buy milk. There are five kinds of milk on the shelves, all at different prices. Cost is not important; you can afford to spend the whole hundred if necessary. The main thing is that it tastes good and is good for your health. Which one will you buy? Let's say that your choice depends on the milk's characteristics and how much you trust the producer. However, you don't trust cheap products, but you also think it is a waste of time to read labels to discover the exact details about the half gallon of milk you are buying. It may be better to buy the more expensive milk since a higher price probably means that it went through a better quality control system. After all, your health is priceless, so you shouldn't skimp on it. Or another scenario might be: milk is just milk—it's all the same. You check the fat content because that is always prominently displayed and choose the cheapest one with the fat content that you want.

The same exact thing happens with company procurement, but on a much larger scale. If we don't keep track of where and how our money is spent, we inevitably lose it. There is no guarantee that you will make the same amount of money tomorrow as you did today. In the previous case, there is no significant factor other than emotion guiding your choice. This won't work at the company level. Even when sales are good, inadequate procurement management can lead to serious losses that could have been avoided.

Interestingly, many procurement executives, even in very large organizations, are unaware of how much their company spends on procurement per year, exactly what financial results are affected by the cost of procurement, or what procurement health indicators exist and how to analyze them. Often, this information stays, at best, at the level of the head of the department. Therefore, in those companies where procurement is limited to transactional support, execution of contracts, and ensuring delivery of goods or services, even after running a tightly regulated tender, many managers do not invest their time into understanding these numbers. Normally, they are not even part of regular reporting, and their value is not always clear.

Suppose we already know how much the company spends on purchasing each year. How much does this cost compare to the company's revenues?

Try to break down these numbers into the factors that have influenced them and work out why this figure changes or, conversely, stays the same. What does it depend on? What would happen to the overall financial performance of the company if this value changed in one direction or another?

What would be the effect on the bottom line if you spent 5%, 10%, or 15% less on your purchases?

When Etihad[1] embarked on its business transformation with the intention of restructuring and expanding its global footprint by creating a single, transparent chain of command, the first departments to be restructured were finance, HR, and procurement. This was not a random choice. Ensuring effective cost management and interaction with external parties that affect the company's viability, especially during a period of rapid growth, is a critical strategic challenge. The three-year project redefined all the core business support processes for several of the companies that make up the Etihad group. It laid the foundation for further growth by increasing transparency in cost management and focusing on strategic issues, transforming transactional procurement management into strategic partnerships with suppliers, and giving the company access to the best technology in the market.

Sometimes you hear that a company spends *too much* on procurement—but there is no such thing as *too much* or *too little* when assessing total procurement costs. Any value must be compared to something in order to be adequately assessed. Is it a lot or a little—compared to what? What is the effect? Why does it matter? What would happen if this indicator changed? Take a seemingly simple indicator such as the unit purchase price. Even if the price is higher for you than for other buyers, in this particular case, it may be optimal or even low—it all depends on what exactly it includes. Different companies may have different requirements in terms of technical parameters, logistics, and additional services such as training or maintenance. An accurate price comparison can only be made by comparing products or services that are fully identical in composition and features, as well as the range of services that go with them. Identical names do not always indicate that the goods are identical.

A similar question may also be asked about the cost of the procurement process itself: How much does it cost a company to support its procurement activities? Here is a simple but very useful exercise to measure how efficiently a company manages its procurement process: calculate how much it costs to place a single purchase order. To do this, you need to find out how many purchase orders the company places per year and the cost of maintaining a procurement department or staff to handle procurement in the different divisions of the company. If you divide the cost of maintaining the procurement department by the total number of purchase orders, you will get the average cost per purchase order. No matter how complex the processes preceding this stage, it is the purchase order that is the central stage of the procurement process, where the intention to purchase something turns into an obligation for both the supplier and the buyer. It is not uncommon for the average cost of placing an order to reach the $100 to $200 range. Suppose it's an order to deliver a single computer mouse at a cost of $10. Isn't the process of placing the order too expensive compared to the cost of the item being purchased? Now suppose your company places 10,000 purchase orders per year. That's a minimum of $1 million for the purchasing process. What if you buy the same things but spend $100,000 less to support your procurement processes?

Of course, all orders are different and reducing them to an average perhaps does not seem appropriate. But if you factor out the negotiations and the organization of procurement tenders, we see that the paperwork is not much different for both small and large purchases. The effort input for the purchase of paper clips is comparable to the effort input for the purchase of cars. The smaller orders for the purchase of paper clips appear to be a less efficient use of resources: instead of spending time preparing to negotiate the purchase of cars, employees waste time on small tenders and placing tons of micro-orders for paper clips from various suppliers at unfavorable terms, while the cost of one shipment of paper clips is probably much lower than the $100 to $200 spent on the administration of this purchase.

Procurement issues have received increasing attention in recent years. All the prominent consultancy groups have developed dedicated areas to help companies improve the professionalism of procurement organizations and make procurement cost management more efficient. It is now understood that procurement has a significant impact on business success. It has become increasingly critical for companies to bring new products to market quickly and spend less on raw materials, components, and services. This has to be done without compromising quality. Finding alternatives, managing demand, and integrating supply chains with suppliers—and even with clients—requires a well-designed supply chain structure and procurement process within it.

Evaluating the effectiveness of procurement is a complex subject. Conclusions can only be drawn after a comprehensive study of the impact of each aspect of procurement on the results of a particular business. The key assumption is that any procurement system is comprised of two dimensions: (1) the strategic, which affects bottom-line value—including developing category strategies and managing the supplier base, and (2) the tactical, which combines many operational steps that are succinctly described by the term *procure-to-pay*.

PROCUREMENT PERFORMANCE MANAGEMENT

Understanding your current position and identifying areas to focus on is a worthy exercise. Start by assessing a small set of basic strategic and operational indicators. There are dozens of key performance indicators (KPIs) for procurement that can be measured. But which ones are high priority? Which ones will help you quickly understand where to focus your efforts?

The business owner or departmental manager should first look at strategic upper-level indicators, such as performance measurement, unit cost estimates, and key financial indicators relating to working capital and savings that are affected by procurement.

If you're a procurement manager, the first thing you need to focus on is the operational metrics of supply discipline, procurement costs, quality, inventory levels, and transactional efficiency through which you assess the achievement of the strategic goals of the procurement function and the company as a whole. Find out what major projects are currently underway, what their KPIs are, what objectives need to be met to achieve them, and what level of operational excellence in procurement is required for projects to perform as expected.

Many developed procurement functions have advanced reporting dashboards that track dozens of indicators. It usually takes years to develop a monitoring system that will be comprehensive yet manageable. It is not so much that automation takes time and resources, but that the populating of such databases happens gradually as the functionality and the processes develop and the real need for a particular metric is understood.

Before you start creating your own set of metrics, it is important to determine which metrics are the most critical to your organization today. What is most important to your company right now? What is the internal understanding of the value that procurement creates? What are the key results of an effective procurement function? For example, if the company is not doing well in terms of supply discipline while also experiencing frequent interruptions, associated capacity downtime, and failure to meet commitments and plans, then procurement is likely to focus on operational performance and on activities aimed at achieving KPI targets in these areas. If baseline performance is good, then it's time to take the next step and look at other areas for improvement.

In order to set up a procurement performance dashboard, you need a starting set of indicators that you will begin to track. The following list describes several strategic and operational indicators that could be taken as a starting point.

- **Strategic KPIs and procurement quality assessments:**
    - **Procurement's impact on the company's bottom line—**this indicator can be measured by the annual amount of savings the procurement unit generates.
    - **Procurement's impact on working capital—**this indicator is estimated through the annual average inventory level, the average level of accounts payable, and advances on procurement contracts.
    - **Share (%) of total procurement spend covered by long-term category strategies[2]—**calculated as the ratio of the procurement spend share covered by the implemented category strategies to total procurement spend.
    - **Share (%) of procurement spend managed by total cost of ownership (TCO)[3] estimates—**this indicator is similar to the previous one and is calculated as a ratio of the share of spend procured based on the TCO value to total procurement spend.
    - **Client evaluation of the procurement service[4]—**clients include both internal and external stakeholders, including suppliers.
    - **Share (%) of reliable suppliers[5] to the total number of active suppliers—**this indicator is calculated as the ratio of the

number of suppliers who received high ratings to the total number of suppliers with whom the company worked on at least one order for the supply of goods or services.

- **Savings (%) on the total volume (value) of purchases—**this measure can also be defined as the ratio of the amount of savings per year to the amount spent to support procurement processes (or to maintain a dedicated business unit). In essence, it tells you how much the procurement department is paying for itself.

- **Operational procurement KPIs:**
  - **Percentage of deliveries of adequate quality that were made within the required timeframe—**this indicator assesses the timeliness and comprehensiveness of supplies of the required products and services. Calculated as the ratio of the amount and/or volume of deliveries made on time to the total amount and/or volume of deliveries for the period.
  - **Percentage of goods that arrived at the warehouse but were not available for production or resale on time as a share of the total volume of deliveries—**this indicator is calculated as the ratio of the total quantity or value of goods that are physically in stock to the quantity or value of the portion of goods that are fully processed in the accounting system and available for use (for instance, goods having been quality checked and ready for release to production or for resale).
  - **The speed of procurement operations—**this indicator can be calculated either by measuring the end-to-end procurement process or its individual parts. For example, the average time from receipt of a purchase requisition to placement of an order with a supplier or the average processing time for deliveries from a supplier to the warehouse.
  - **The cost of procurement transactions—**this represents the average cost per purchase order placed and is calculated by dividing the total cost of supporting purchase orders by the total number of purchase orders for the period. Process support costs include staff salaries, costs associated with their activities, infrastructure maintenance costs, and energy and material costs.
  - **The volume of deliveries that did not pass quality inspection—**this indicator is the ratio of the value of the products

and services with quality claims to the total value of all delivered products and services.

- **Working capital indicators:**
    - The average level of inventories and the amount of obsolete inventories compared to target levels
    - The share of advance payments that are overdue, i.e., products and services paid for, but not received on time
    - The average level of accounts payable in days
- **Share (%) of framework (long-term) agreements to the total number of agreements**—this indicator is calculated as the ratio of the number of agreements with a duration of more than one year and the possibility of placing multiple purchase orders to the total number of agreements.
- **Operational indicators that measure the efficiency of resource allocation and the load on the procurement service:**
    - **The cost of running the procurement unit**—considered the ratio of the total cost to run a procurement function to the total value of procurement savings.
    - **The amount of procurement spend managed by one procurement officer**—calculated as the sum of the total annual spend on all categories for which the procurement unit is responsible divided by the number of staff in the unit. It is worth noting that the proportions will be different for different categories. For example, a raw material category may contain only a few items and still account for the largest proportion of costs, while a consumable or spare part may be relatively inexpensive and still have hundreds of items, making the category difficult to manage. Therefore, it does not make sense to calculate this value in relation to specific categories.
    - **The number of active suppliers per procurement officer**—this is the total number of active suppliers divided by the total number of procurement staff. As with the previous metric, you shouldn't make calculations by category—the purpose of this metric is to estimate employee workload and the labor costs involved in managing the counterparty base.

  - **The number of purchase orders per procurement officer—**calculated as an average figure where the total number of purchase orders is divided by the total number of procurement staff supporting them. This indicator reveals the average amount of workload per employee without reference to the complexity of a certain deal.

How to interpret these estimates and understand when the values of individual indicators are acceptable will be discussed in Chapter 2, where we will talk about benchmarking as a way of setting target levels of procurement performance.

The basis for introducing KPIs into management practice is to get a clear understanding of the tasks they address. The main tasks for which KPIs are used are highlighted here:

- **Measuring the achievement of the goals—**what is not measured cannot be evaluated. However, evaluation is not just about numbers. There are also qualitative indicators that can be obtained from peer assessments. It is possible to understand how your objectives are progressing and how close you are to achieving the goal by tracking key KPIs that take these goals into account in measurable terms.
- **Identifying areas for improvement—**only through performance indicators can one understand what the priorities should be in the short and long term and what exactly needs to be improved. KPIs will not always answer the question as to exactly what improvements should be implemented because many factors can directly or indirectly influence the numbers, but only measurable performance indicators will point in the right direction.
- **Increase transparency—**regular tracking of KPIs will enable real-time monitoring of the procurement process and allow us to observe how well the function is delivering on its promises to clients, including internal stakeholders, management, and suppliers. If any of the targets are not achieved, the causes of the problems can be found through the use of intermediate performance indicators.

Successful achievement of the intended KPIs in procurement will lead to the following results:

- **Improved business financial results—**savings and spend optimization
- **Improvement of the company's working capital—**average level of contract advance payments, accounts payable, and inventory balance

- **Timely and full supplies—**delivery rates, On Time In Full (OTIF),[6] and ratio of noncompliant deliveries to total deliveries
- **Compliance with regulatory requirements—**volume of noncompliant transactions, ensuring timely financial period closure and filing for tax refunds
- **Achievement of client expectations—**stakeholder satisfaction index, management assessment of procurement performance, and supplier loyalty index
- **Improved contract performance discipline—**number of claims, quantity, and quality deviations

Each indicator is based on its own set of inputs and has a number of features that need to be considered in practice.

Take, for example, the inventory level metric from the working capital set of indicators. Excessive inventory has a negative effect on working capital, so companies try to minimize inventory. Different industries have different inventory strategies: in retail, it involves managing product assortment and availability to customers; in manufacturing, it involves holding a safety stock of critical spare parts that may never be needed, but its absence could lead to production disruptions. Companies are therefore looking for approaches that would allow them to maintain inventory at an optimal level, where they have enough stock to guard against lost productivity and profits while at the same time ensuring that unnecessarily large funds are not deducted from working capital by being locked up in excessive inventory.

One often hears that the entire responsibility for a company's stock rests on the shoulders of the procurement office because they are the ones who buy in advance to insure against unforeseen additional demand and to make sure they don't buy the same goods twice. But this idea is inconsistent with the reality. The delivery of goods is preceded by a planning process that starts with those departments that need these items—way before the procurement office steps in. The purchasing plan could be influenced, for example, by maintenance plans or construction plans for new units. In fact, it often happens that these plans are not fulfilled for various reasons and the ordered stock ends up sitting in the warehouse. Who has more influence on the stock level then? Is it the procurement department that secured the order and brought the goods to the warehouse, or is it the department that ordered the goods and did not use them in a timely fashion? Going further, the requestor argues that the stock was not used because the delivery was two days late, which shifted the entire work schedule, and therefore high stock levels in the warehouses are the fault of the procurement department. Procurement responds that they could not deliver the goods earlier because the client submitted the requisition two weeks after the required deadline. Also, in general, it is not just the client who influences the delivery time, but also logistics operators, stockkeepers, and even management, who can sign the necessary documents immediately or delay it a month.

Another equally controversial indicator is procurement savings. Let's say the purchasing department has identified that an analog (substitute) version of the equipment or material that the customer has requested is available on the market. The analog is cheaper, and there is no need to change their technology cycle to use it. In this case, it's simple: the savings achieved are a feather in the cap for the procurement department. But what if a technology process change is required to use the analog version? Without the help of engineers and changes in the manufacturing process, making the switch would simply not be possible. What sense would it make to talk about savings in this case?

On one occasion, my colleagues and I argued at length about how to account for procurement saving's contribution made by the procurement department and internal stakeholders when several different departments were contributing to the overall savings. Several suggestions were put forward: a 50/50 split; calculating each initiative effect in proportion to the number of hours invested in the project; involving a third party such as financial controlling to measure the inputs properly, etc. By trial and error, we found that the only correct solution was a very simple one: to share the benefits together without the need to calculate the share of each department's input. It is simply a matter of cross-functional team responsibility for overall performance indicators and working together toward a common outcome where everyone gets rewarded for team results. This approach helps to free up precious resources that can be spent finding new ideas and helping each other rather than on the arguments about the size of contributions to the common cause. After all, if the team wins, everyone wins.

Colleagues have often asked me about the use of service level agreements (SLAs). This management tool may be somewhat controversial. Indeed, while internal clients expect procurement to provide on-time delivery, and this is their requirement for a specific service level, procurement depends on the speed of warehouse operations and the timeliness of each purchase requisition created by the internal client, so it seems unfair to set a one-sided SLA that defines requirements toward procurement only. In order to balance the responsibility between all involved parties in the process, requirements can be defined on the speed of planning, paperwork quality, the speed of shipment of goods to the warehouse, the timeliness of purchase requisitions, and even the quality of technical specifications. In the early stages of procurement process development, SLAs might work well. But if applied excessively and directed to the responsibility of one side only, sooner or later it starts to provoke disputes and the shift of responsibility. One can always say, “I am doing my job, but things are going wrong because my colleague isn’t doing theirs,” without helping their colleague solve the issue. The expectations toward each other are too formalistic in this case. Such a formal approach might work when processes and functional operations are clearly defined and independent of each other. When it comes to joint initiatives or projects in which it is not very clear at the beginning exactly what the most appropriate long-term performance indicators are and how to achieve results, it is better to learn to communicate and agree on what everyone needs to do for common success rather than spend time defining SLAs. This will bring much more benefit to the common cause.

Another important aspect of working with performance indicators is that, in some cases, setting targets that are too high (difficult to achieve or simply unrealistic) can lead to the manipulation and incorrect reporting of results. Such risks need to be anticipated. Here is an example:

> When my team first introduced OTIF to procurement, we set ourselves the ambitious goal of ensuring day-to-day delivery accuracy. At that time, we had already been working in a paradigm of shared, cross-functional responsibility for our performance, including tracking warehouse operations speed. Things did not look good at first: incoming goods were processed with long delays, and the warehouse’s stock receiving records could have been better. The speed of this operation was estimated based on the difference in date and time of two events: a shipment notification from the supplier[7] and the goods receipt document. We tightened the target for the time between these two events and started to track in the system when each of the documents was logged. There were no external reasons to indicate that this new target was not achievable. Quite soon, a few warehouses began to show improved results, but at the same time, buyers complained about the speed of goods acceptance in these same warehouses. Upon closer inspection, we discovered that we had not accounted for possible risk: the shipment notification was not created by the suppliers in our systems; it was logged in the accounting system by our storekeepers, just like the goods receipt. It turned out that the incoming goods receipts documents were not created in accordance with the actual timeline but instead were created together with the shipping notification. Employees did it on the same day and time even if the shipment notification from the supplier arrived days earlier. This shortened the timeline of the incoming goods processing, thus improving KPI reports but not the real processing times of deliveries.

Another scenario is also possible. Employees make every effort to achieve the new target, but the goal is unrealistic and unlikely to be achieved unless there is a change in processes, responsibilities, and infrastructure. Even if management is motivated to set ambitious targets and test the team's capabilities, any ambitious goals must be supported by sufficient resources and process improvement. An *ambitious* goal is one that is slightly daunting but still achievable—even if, at first glance, it is not entirely clear how to achieve it. Continuous process improvement, the implementation of adequate controls, and the development of employee competencies will help to achieve these ambitious goals.

My favorite indicator of procurement performance is *return on investment* (ROI).[8] This indicator can be based on various methodologies, and procurement managers can develop their own, too. According to some consulting studies,[9] developed procurement functions deliver savings of 10 times or more their operational costs. The procurement ROI is the ratio of the amount of annual procurement savings to the amount of annual procurement operating costs—including salaries, travel, training, offices, stationery, equipment, utilities, external services, etc.—that are associated with the department's operations. That procurement savings figure will be the subject of a separate chapter, but for now, I will just say that this figure has often helped me justify changes that required heavy investment and quite expensive training for procurement employees. The procurement department manages a large volume of spend, and how well these teams perform depends on how much value they can create for the same money. A procurement department should be able to pay for itself. If this is not happening yet, investment in the development of this function should help.

While KPIs must be used to measure procurement efficiency, I would also like to caution against getting too carried away with them. There is a huge variety of KPIs, but not all of them need to be applied immediately to your organization. In addition to a standard set of KPIs that cover end-to-end processes, each stage of procurement maturity will require a different set of applicable KPIs. Here are a few rules for working with performance indicators:

- **If the indicator cannot be tracked due to lack of data or the organization is not ready for it, do not use it—**there is absolutely no point in trying to achieve something that cannot be measured or understood. Instead, it is better to select metrics that are as close as possible to what you want to measure in order to help guide the achievement of the desired outcome.
- **Use the number of indicators that you are able to remember—**you should not waste your time creating a complex dashboard with 99

indicators that resemble an airplane cockpit. A manager, or any other specialist, will, at best, monitor 10 indicators and is unlikely to look at the rest. Therefore, they will have no influence on the decision-making and operating processes.

- **Always discuss with the team why certain indicators are needed and how they will be measured, as well as define responsibility for their implementation—**test an indicator for a year before introducing it. We regularly calculated them and checked their adequacy through feedback from the procurement team, customers, and suppliers. Only when we were sure that a certain KPI was understood by the team did we introduce it as mandatory, thereby affecting performance evaluations.
- **Some indicators may be tracked over a long-time horizon only—** this applies to those indicators that depend on specific factors such as seasonality and market trends. In the case of a category that has volatile price and supply-demand balances, it is not appropriate to draw conclusions about the effectiveness of cost management over the course of a week or month, but the chosen methods may well be worthwhile over the longer term. It is better to measure effectiveness and savings over the long term when results can be more accurately verified.

PROCUREMENT CUSTOMER EXPERIENCE EVALUATION

One procurement performance indicator that is difficult to find in public sources and benchmarking studies is the evaluation of the procurement function's performance by internal clients (or customers) and suppliers.

While other indicators can be calculated and acceptable values determined, there is always much debate surrounding the objectivity and value of customer evaluations. Service level assessment is a typical indicator for service companies and functions. At the same time, there is a view that such assessment is driven by emotional reactions rather than real facts, thereby harming the teamwork of procurement with related departments. The evaluation of results through customer experience surveys is subjective because people usually forget or take for granted hundreds of successful cases but will always remember that one failure to deliver on time for an important project, thus guaranteeing a bad evaluation. That's just human nature—we more easily recall things that evoke strong emotions. Therefore, stressful situations where someone lets us down are going to be top of mind even if there are 99 brilliantly executed operations for every one single mistake.

The subjectivity of the customer experience indicator is indeed a challenge, as there is no standard methodology for its measurement. Given the specific nature of the work of buyers, especially in cases where the company has a high share of maverick spend or urgent purchases and the timeliness of planning and the quality of terms of reference suffer as a result, the usefulness of such an assessment may indeed be questionable—its sloppy application has a strong demotivating effect on employees.

Some procurement professionals are not very fond of the *service function* term. Indeed, the very concept of a client-provider relationship can prohibit us from understanding that results are achieved through the *joint* efforts of a team of professionals who, in most cases, do not depend on a single function. And in this sense, it is more correct to speak not about the relationship between the client and provider, but about building teamwork when both procurement and those units that order goods and services put their efforts into achieving a common result. All business processes are interconnected, which means that any action or inaction affects the entire end-to-end process. By introducing a customer satisfaction assessment, we reinforce the client-provider boundary.

Nevertheless, procurement is, by definition, a service function. With that said, I am convinced that procurement can do much more than buy and deliver. The tasks it performs directly determine the profitability of the business and, in many ways, also the processes of production and the functioning of the company as a whole through the creation of added value, such as cost savings and faster delivery times for products or services.

The service that procurement provides is the timely and cost-effective provision of goods and services to operations and administrative units so they can help the company meet customer needs. The clients, or stakeholders, of a purchasing service are not just the company's divisions, but also its management and suppliers since the quality of the purchasing service and the reliability of its processes determine whether suppliers can provide a quality service on time without defects. It can also allow a company to buy more of the goods and services it needs without increasing its spend. It's all about the interpretation of *service*. The mere fact that procurement is a service function does not negate the responsibility of its clients for the overall outcome of procurement (e.g., think in terms of the quality and timeliness of planning).

The procurement process begins at the planning stages of the required good or service. And how this first part of the process is carried out determines the quality and speed of all subsequent steps. Within a company, customer-oriented service is always a two-way process since each function *consumes* the results of the other and passes the results of its work in the form of products and data down the chain and returns them to the starting point—the client who ordered the products or services. Let's take a closer look at a customer evaluation performance metric based on the experience of a large telecom company's Chief Procurement Officer.

> "It is important to build the right image of the procurement function in the eyes of the client as a business partner, and to do this through the regular collection and detailed analysis of feedback.
>
> In our case, there was no way to make peace with internal customers until we organized the collection of feedback in the form of evaluations from each internal customer on completed procurement transactions. Before that, there was a constant backlash against procurement performance at the CEO and board level—one thing after another was always wrong. It was just the case that negative experiences with procurement were often escalated to the highest level by the internal customer, while achievements and successes were hardly ever brought to the attention of senior management. Collecting systematized feedback from a large sample of respondents showed that this negativity was shown to be baseless, as it turned out that there were far more successes than shortcomings and, in fact, the overall picture was positive. As a result, the negativity was de-escalated, as we were able to operate through facts, not just emotions."

There is an expression (and a book by the same name) that is apt in this situation: "A complaint is a gift."[10] If no one is complaining about the quality of your service, it may not be because the service is perfect, but because it is seen as so hopelessly bad that customers don't even try to tell you about it. And if you don't ask for feedback yourself, you may never know there are problems. I think using and numerically scoring customer and supplier assessments provides clues as to where improvements are needed. Here's why:

- **Scoring makes it possible to navigate the objectives and helps to measure the results—**we cannot say that everything is good if we have collected fewer complaints this quarter than in the previous one. However, a scoring system helps to account for the significance of events and evaluate overall service perception rather than just count complaints and omit the rest of the feedback.
- **Having a measurable value allows you to set a target for improvement—**if the current score is 3, you can set a goal of raising it to 3.25 over a certain period of time. Then, as successes build, raise it again. Do not make a target like this: *no more than five stakeholder complaints in the next six months*. This is meaningless because it may not be commensurate with the actual number of tasks that procurement performs in the same period of time or their complexity.

- **The existence of an evaluation scale makes things easier for questionnaire respondents.** A scale makes it possible to give a score without lengthy explanations. All financial KPIs can be met but yet the procurement function can still score low on *customer focus*. If achieving a financial KPI means creating inconvenience or problems for others and causes misunderstandings among stakeholders, then something is wrong, and the approach needs to be changed.

Even when there is a score-based assessment, how it is done is important: the way in which feedback is collected has a direct impact on the conclusions drawn and how practical they prove to be. Clients are not always capable of being honest when feedback is requested face-to-face. Perhaps they are too embarrassed to criticize their colleagues and are willing to hide certain problems because they do not consider them critical, whereas, in fact, these problems are systemic in nature and could easily be corrected if voiced. Therefore, formalized questionnaires are a good complement to live communication, and their format and content determine how willing respondents are to provide feedback.

Experience shows that asking a lot of questions does not guarantee you will uncover particular insights, but it does make collecting and processing feedback much slower, and if a survey takes more than two or three minutes to answer, it is far more likely to be ignored. The most successful evaluation systems are those where feedback can be given immediately. This is the approach used, for example, by taxi services—the customer can provide feedback and evaluation *on the fly* while the experience details are still fresh in their minds. This method requires the use of automation, and the design of the evaluation system must ensure that colleagues are not overwhelmed with endless feedback requests after each order has been fulfilled. When feedback requests come too often, they are likely to be ignored, too.

Some companies use the Net Promoter Score (NPS) index for internal services evaluation purposes. This indicator asks if the customer is willing to use the same service provider or recommend it to others. In the case of a restaurant or goods manufacturer, using NPS to assess a customer's willingness to return or recommend the company to colleagues and acquaintances is understandable. But internal customers cannot, in principle, refuse to use a company's procurement service: they usually have no authority to buy on their own, and the question of recommending to colleagues or friends when there is simply no other choice makes the index irrelevant.

The following paragraphs contain a brief version of a questionnaire we have used in order to help evaluate the service level of our internal procurement function. It generally provided useful data and gave us reliable benchmarks. A semi-annual questionnaire was sent out to clients with just three statements whose validity the respondents were asked to rate:

1. The goods and services procurement function usually meets your expectations.
2. The quality of delivered goods and services usually meets your technical requirements.
3. The quality of interaction with procurement meets your expectations.

The proposed multiple-choice answers provide varying degrees of confidence, as there are almost no *black-and-white* situations:

- Strongly agree
- Partly agree
- Partly disagree
- Completely disagree

The difference between *partly agree* and *partly disagree* is that the first option is more likely to be chosen by someone who is generally satisfied with the interaction, but with some room for improvement. In contrast, the second option is chosen by someone who is rather dissatisfied with the service.

The evaluation process itself consists of three steps:

1. Conducting a survey using the aforementioned questions
2. Processing the results
3. Requesting detailed feedback on the results of the questionnaire through personal interviews with select respondents.

Why do we need a questionnaire if we have a third step with the same questions being posed in an interview? The logic can be explained as follows:

- Through the results of the questionnaire, we can see which departments have the most issues in interacting with the procurement function
- The questionnaire covers many participants, and interviews are conducted with select groups to discuss the results and propose possible solutions to identified systemic problems

When we add the results of the interviews to the survey score, we get an impressive set of data—comments and suggestions that become part of an operational improvement program or serve as a basis for revising the elements of the function's development strategy.

During the interview, you can use the Customer Journey Map (CJM) toolkit.[11] A CJM is an approach where you put yourself in the client's shoes and try to experience how the process actually works. You can simply observe the process, carry out in-depth interviews, act out parts of the process together with the client, or in the most radical variant, become the client yourself. This approach has proven to be excellent; there is nothing better for identifying areas of improvement than going through the procurement process from the client's perspective.

In addition to interviewing internal clients, it is equally useful to interview suppliers and procurement staff. In order to gather a truly complete picture, it is important that feedback is comprehensive and comes from all process participants.

You can find out from suppliers what difficulties they face in the supply process: what works, what needs improvement, and what possibly triggers unnecessary costs on the buyer's side that they are unaware of—for example, in logistics or labor costs. Don't assume that all suppliers will be silent or try to cover up issues; some will take part in the survey but remain silent about the main pain points, some will ignore it altogether, but there will be those who will want to get involved and give detailed feedback in order to change things for the better. After all, if you ask, there is a chance of getting valuable information, but if you don't ask, the likelihood of this will be zero.

You can find out from the purchasing staff what hinders or helps them in their work, with which clients and suppliers, on what occasions the most difficult interaction issues arise, and what solutions they suggest to overcome these problems. You can get a lot of ideas from your team members, even if they are not always obvious, immediately applicable, or require adaptation—they are nevertheless no less relevant. Ideas arise through conversations, daily interactions, and of course, special surveys that allow for anonymous responses. Surveys do not have to happen often; it is just essential that this channel of communication exists.

KEY CHAPTER IDEAS

- There is no universal method for determining optimal procurement costs. It is only possible to determine whether procurement costs are elevated by comparing average prices with market indicators and the costs of running a procurement unit or performing individual procurement operations through benchmarking.
- Not all procurement performance indicators are necessary or appropriate for a particular company. It is important to focus on the current goals and strategy of the business and then determine which indicators need to be monitored.

- Indicators can tell you that all is well when the reality is not so rosy. You need to correlate metrics with the results of feedback from employees, internal clients, and suppliers. Formalized metrics are only one small part of the big picture.
- Targets should be ambitious but realistic. If they are too high or if there are too many, processes don't change, and employees won't feel empowered to help. There is a good chance that employees will likely just try to game the system than do effective work.
- Do not think of customer satisfaction as a one-way metric. Any indicator depends not only on the performance of the procurement unit but also on other departments. It is a useful practice to introduce shared responsibility between procurement and clients for certain performance indicators, such as savings or inventory levels.
- Interviews with stakeholders and customer-focused procurement assessments are a valuable source of information about areas that may need improvement. However, it is important to review the timing and type of surveys used to get the most comprehensive picture.

ENDNOTES

1. Etihad Airways is the national airline of the United Arab Emirates. Material from the Procurement Directors' Roundtable, 2016.
2. A long-term strategy is usually defined for a period of one to three years or more. The longer a strategy's horizon, the lower the accuracy of the forecasts it makes, as the market is not static. Long-term strategies should be reviewed at least once a year.
3. TCO is the sum of all the costs of acquiring, operating, and disposing of a procurement item throughout its lifetime.
4. The term *client* in procurement means a representative of any department other than procurement that submits a requisition and will directly use or consume the product or service that has been procured.
5. Criteria for supplier reliability can vary and are defined when developing a supplier management strategy. Often these criteria are the promptness of order fulfillment, product quality indicators, quantity of claims, etc.
6. This indicator consists of two parts: on-time delivery and completeness of delivery; it has many variations—different companies calculate it differently depending on their process design.
7. The availability of this document depends on the features of the ERP/accounting system.

8. In this case, it is the return on investment of the procurement function specifically.
9. Kearney's Assessment of Excellence in Procurement survey.
10. Janelle Barlow and Claus Møller. *A Complaint Is a Gift: Recovering Customer Loyalty When Things Go Wrong*. Berrett-Koehler Publishers, 2008.
11. Some useful reference materials can be found in the Addendum with the list of recommended books.