

# Impacting the Bottomline: Supply Management's Financial Strategies

By John Yuva and Tim Underhill

John Yuva is a writer for *Inside Supply Management*<sup>®</sup>. Tim Underhill is president of Underhill & Associates, Tulsa, Oklahoma.

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**Every department and supplier is a potential resource and opportunity for supply managers to make a financial impact to the organization's bottomline.**

## Points of Interest

At a glance, here are the main points covered in this article. By reading it, you will learn:

- The challenges that supply managers face when attempting to move beyond a first price paid/landed cost focus
- How to gain a total cost outlook by measuring suppliers based on performance, value-add and price
- How supply managers are becoming more financially strategic
- Financial ideas abound from suppliers with tactical and strategic ability

Companies today are looking for ways to reduce their costs and improve bottomline performance. Nearly every supply management organization has refocused its efforts on reducing the price paid for goods and services. However, supply managers are in a unique position to accomplish much more, because the suppliers they buy from can impact operating costs in nearly every function of their organization. To make that impact a reality, supply managers need to look beyond the "first cost" focus of their suppliers. They need to become more strategic in their financial endeavors and have a more holistic view of the financial aspects of the organization. Developing such a perspective and taking a strategic initiative to internal customers can lead to total cost reductions throughout the enterprise well beyond the price paid for goods and services.

However, an initiative of this type can be difficult to accomplish. Many organizations continue to operate in silos where internal business units have different objectives and are evaluated on different financial goals. So how do supply managers overcome these challenges and make a bottomline impact on the organization? In addition to highlighting the challenges that exist, the following areas will provide some strategies toward moving beyond price and into total cost areas.

- Taking a total cost outlook
- Moving into financial strategic activities
- Supplier financial ideas abound
- The leading-edge financial approach

When addressing the challenges that organizations and supply managers face when attempting to move beyond a first price paid/landed cost focus, three primary issues exist: (1) accountability: supply managers are not held accountable, or rewarded, for financial impacts beyond their price paid and inventory carrying costs; (2) measurement: inability of the organization to measure total cost; and (3) time: lack of time to pursue total cost objectives.

**Accountability.** Within their organizations, supply managers have tasks, goals, objectives or expectations for which they're accountable. It's these areas of accountability that are critical in the organization's evaluation process and compensation system. Thus, supply managers' financial accountability is often first cost (price paid) or landed costs. While many are also examining first-level possession costs (e.g., number of transactions, inventory carrying costs, performance costs, etc.), few are going beyond these areas because it's difficult to justify pursuing other cost reduction opportunities when the price paid, the cost they are accountable for reducing, can often go up as these other costs are reduced.

**Measurement.** Often supply managers know that they can make a more significant bottomline impact by working with the supplier to reduce total cost. However, the difficulty comes in measuring it on a total cost basis. Without the ability to measure the impact, supply managers cannot make a sound financial decision. They know by paying a little more they can reduce total costs, but they do not have the ability to evaluate how much more they should be paying their suppliers. What is the worth of the value suppliers add (e.g., higher-quality products, reduced downtime, quality service, etc.)? Without knowing how to measure on a total cost basis, supply managers are unable to demonstrate the financial impact to the bottomline. The result? Many supply managers must base their supplier purchases on price, especially if they're accountable for measurable cost reductions.

**Time.** What is keeping supply managers from measuring total costs? In many cases, it's time. A supplier may be able to provide cost reductions in engineering, manufacturing or production, but supply managers lack the technical skills and time to evaluate these areas to truly place a value or cost on the savings the supplier might be able to impact. Consider the following four factors organizations typically use in choosing a supplier: (1) price, (2) quality, (3) service and (4) technology. Each of these is important, but other than price, most organizations have not developed the ability to measure the total cost differences in these areas or lack the time to do so. Thus, a truly engineered product or value-added service is often treated as a commodity and the impact on total cost is overlooked.

### The Short-Term Financial Perspective

If there's an incentive for supply managers to maintain a first price/landed cost perspective, it's that many organizations are tuned in to short-term savings. It is appealing to organizations and their shareholders to see savings attained today versus savings that may or may not accrue over time. To meet these expectations and receive credit for their efforts, supply managers can turn to supplier pricing for quick, attainable results (i.e., choosing the lowest-cost supplier). For example, an organization is building a new plant and one of the supplier requirements in the bid is that the products installed be supplied with a two- to three-year warranty. While the engineering company with the winning bid will accommodate that requirement, there are product alternatives with a life cycle of 10 to 20 years, but they cost more. The supplier does not put these forward for fear of losing the bid, so the organization misses the opportunity to keep future costs low as a number of products will need to be replaced three years later. An investment in higher quality at the beginning may have spared the organization from spending more money if the value from the higher-quality products could have been measured and compared against the increased cost for buying them.

Consider instances in which suppliers provide cost-saving ideas. In some cases, these ideas are rejected by the supply management organization because they involve spending more today for more savings tomorrow. For example, an organization requires its supplier to make a reduction in total cost. The supplier says that spending \$250,000 more per year on a higher-quality valve will save the organization \$2 million in energy costs. While the proposal meets the organization's cost reduction requirement, it's rejected because of the organization's uncertainty about the savings and its refusal to allocate more money for the new valves. For suppliers to provide savings beyond price and really impact total cost, it's going to require a give-and-take relationship between both parties. Thus, is a short-term outlook truly capturing the savings available to the organization?

According to R. David Nelson, C.P.M., A.P.P., vice president, global supply management for Delphi Corporation in Troy, Michigan, "Most companies are ignoring 20-30 percent of the opportunities that exist in their supply management operations today." Of these opportunities, price paid may only be a small portion of what's attainable. A spend analysis will reveal areas to reduce the supplier base and leverage purchases, but additional efforts are needed for supply managers to make total cost reductions. This means there may only be 5-8 percent savings in price and the remaining 15 percent will require supply managers to explore true value-chain opportunities with their suppliers. Such an approach offers the potential to make a major financial impact on the bottomline.

### **Taking a Total Cost Outlook**

To make a total cost impact and capture the 20-30 percent that's available, supply managers should try to become better financial analysts. This requires developing a standard method that the organization can use to identify total cost opportunities. An example is total cost indexing, which is a methodology for measuring total cost and the resulting financial impact. It is the basis for explaining why the organization should pay five dollars more in order to save twenty dollars. (For more information about total cost, visit the ISM Web site at [www.ism.ws](http://www.ism.ws) to read such articles as "[Strategic Cost Management Programs: What's the Plan to Follow?](#)" and "[Determining Total Supply Chain Costs.](#)")

How do supply managers gather the information to measure total cost effectively? It requires examining the supply base of internal customers and determining what their essential needs are from the supplier as well as from the supplies they're receiving. The challenge is that supply managers have difficulty measuring on a product-by-product basis. Most companies find that to do this effectively, they must significantly reduce the number of suppliers they purchase from, and then work closely with the remaining suppliers and their internal customers to achieve the savings. This process often requires the supply management organization to stop managing the supplies and start managing the relationship with the supplier. This approach focuses supply managers on total cost areas such as the performance levels, true value-add products and services, and of course price options. A team approach with the goal of measuring a variety of areas will provide a clearer picture of the total cost impact of the supplier on the organization.

From these three cost areas, supply managers can create a total cost index that allows them to compare suppliers on a total cost basis. In essence, total cost indexing provides more information to make a sound financial decision. By measuring suppliers based on performance, value-add and price, supply managers can present a model of comparison between price paid and total cost. Senior management may ultimately choose a savings option based solely on price or it may find justification in paying more upfront in order to save more in other areas. Either way, the comparison provides the ability to make financial decisions that are sound and in the best interest of the organization.

The result is greater credibility for supply management, as well as recognition that procurement has more of a financial impact on the organization. Often supply managers are focused on supplies, which leaves little to no time for strategic or tactical activities. To overcome this, it's important to find supply managers who are innovative thinkers and who have the analytical ability to divide the supply management function into three sections: transactional, tactical and strategic. While the transactional function needs to continue, supply managers with tactical and strategic functions can engage in critical activities within organizational teams and become true partners that internal customers want to work with.

### **Moving Into Financial Strategic Activities**

Becoming financially strategic involves finding out what is important to other internal business units beyond the price paid for goods and services. For example, what are their challenges that impact the bottomline? What are they getting evaluated on and the resulting financial

implications? What are their supplier concerns that impact cost? It is only after supply managers understand the true needs of their internal customers and what they're accountable for financially that strategic financial activities can take place. Why? Because it's not until that point that they can begin to examine suppliers that have the capabilities to aid in fulfilling the goals and financial needs of internal customers.

At Atlanta-based Cox Communications, the procurement team has taken on a strategic financial initiative with the goal of attaining \$15 million to \$20 million in savings every year. Most recently, the team chose a reverse auction strategy in an effort to leverage the organization's spend in several commodity segments. With the senior management at Cox constantly searching for ways to drive out cost, Sherryl Love, vice president, supply chain management, says it wasn't difficult to convince them to consider a reverse auction strategy. After educating the senior team about the reverse auction process, it was excited about the tool's potential. "We invited senior management to watch us conduct the auction and see the results, which many of them did," says Love. "The auction was so successful that it became the talk of the senior team's staff meeting the following Monday, with discussions about how much money was saved and how the process worked."

Love says the team chose a commodity that was purchased by its individual systems with the goal of standardizing the commodity, leveraging its spend and driving out cost. "While the first auction was a learning process and took much longer to conduct than we anticipated, the second auction was much smoother because once you go through the growing pains of understanding how to put a reverse auction in place and educating the suppliers, it gets easier the second time around," she says. "The reverse auction tool allowed us to leverage our spend with a savings of approximately \$2 million for the first auction and \$1.1 million for our second auction."

Cedar Rapids, Iowa-based Rockwell Collins, a leader in the aerospace industry, implemented a strategic communication link between the company and 450 of its suppliers (approximately 85 percent of its direct material transactions) in the form of a supplier scorecard, which has led to cost savings in the area of supplier performance. The scorecard is part of the company's online supplier portal and provides supplier feedback about quality and delivery performance, as well as a subjective score that addresses non-price elements that are important to the company's bottomline. Roger Weiss, vice president of material and supply, says that to make the scorecard more strategic, Rockwell Collins created a monthly e-mail alert. "We've found that finding the right person in the supplier organization who cares the most about Rockwell Collins (e.g., presidents, vice presidents and owners), and ensuring that he or she receives a monthly summary report about details in the scorecard, bridges the performance goals and expectations between Rockwell Collins and our suppliers," he says. Weiss adds that the scorecard has been a major influence in increased supplier delivery performance. Within the past year and a half since the scorecard was deployed, supplier delivery performance has increased from 84 percent to 95 percent.

### **Supplier Financial Ideas Abound**

While 12-15 percent of supply management organizations will be engaged in tactical and/or strategic areas, less than 10 percent will be true strategic supplier alliances where organizations will grow with their suppliers. Bottomline: Only a few suppliers will have the ability to make a significant total cost impact. Growing with a supplier, however, requires developing new strategies and not discounting supplier ideas. Without this strategic development, organizations will reach a point of diminishing returns. Thus, supply managers should consider the following questions: What are the costs that they want to focus on, how can they improve the bottomline throughout the supply chain and what is the best opportunity to do this? The source of answers to these questions is key suppliers with tactical and strategic ability that want to work with the supply management organization and provide ideas.

A best-in-class example is BP Amoco and its effort to be one of the environmental leaders in the oil and gas industry. The company began examining fugitive emissions into the environment and possible leaks in its valve systems. Through its work with suppliers, BP purchased higher-quality valve lines that didn't leak hazardous emissions into the environment. While the company spent more on higher-quality valves, the return on investment to BP was substantial. By reducing the leaks in a plant based in England, the company was able to increase its product output of acetic acid by 20,000 tons. In a Texas City plant, energy costs were reduced by \$2 million. A plant in New Mexico was able to increase its output by 1.8 million cubic feet of gas per day. By paying more for the right product, BP was able to make substantial reductions to its bottomline. Most organizations wouldn't think of their suppliers as having the capability of generating this type of result.

Consider the collaborative relationship between Rockwell Collins and its suppliers. The company's supply management process has a commodity team structure. Guiding the enterprisewide sourcing strategies is an internal supply chain steering team (SCST) comprised of senior leadership from all functions of the business including engineering, manufacturing, procurement, etc. In addition to acting as the internal governing body for the sourcing strategies, the SCST also mentors the commodity teams. Weiss says that the company also looks for similar guidance outside of Rockwell Collins, hence the formation of a supplier advisory alliance council (SAAC). The council is represented by 18 suppliers that meet three times per year with the SCST to help set Rockwell Collins' strategic direction. "The membership of the SCST and the SAAC is our sounding board or board of directors for the company's supply chain management processes," says Weiss.

How has the SAAC been instrumental to the strategies and financial outcomes for Rockwell Collins' supply management function? Weiss explains that during the initial design phase of its previously discussed supplier scorecard, the company sought feedback from its SAAC about what an ideal scorecard should include. What are great examples that SAAC members have seen from other customer scorecards? What elements of a scorecard are beneficial? What doesn't work well for a scorecard? This feedback was used to design and craft the company's supplier scorecard.

However, Weiss says that the scorecard really became a strategic tool when the SAAC members discussed how the scorecard information should be disseminated. Rockwell Collins talked about making it a real-time, daily updated supplier tool, but its suppliers recommended a monthly update to alleviate their already high number of day-to-day management tools. The advisory council also requested that rather than accessing the scorecard information from a Web site, the senior leaders wanted the information sent to them with a summarization of their performance. "Our SAAC was instrumental in deploying the right tool that hit the mark with our suppliers to give us maximum benefit," says Weiss.

The advisory council also provided a financial benefit to Rockwell Collins' sourcing team that was working with its magnetic suppliers. Weiss says that a SAAC member offered information about some archaic specifications surrounding a vibration test. While the specifications were on target at the time they were written, changes in process controls made the test invalid. "This particular supplier came forward and explained that by removing the test requirements, it could save our company a large sum of money," he says. "We characterized and examined it, and within two months implemented the opportunity, which equated to \$120,000 in annual savings."

For Cox Communications, the success to its reverse auction strategy was the education and information provided to suppliers. Cheryl Hobgood, supply chain strategist for Cox Communications, says that there's a lot of upfront work when establishing a reverse auction, but that's a good thing because it pays off in the end. "From our perspective, it helped our suppliers understand clearly the requirements and specifications, while helping us to achieve competitive pricing," she says. The following are the primary steps in the development of Cox Communications' reverse auction:

- Created defined specifications for products appearing in the auction (allowed for standardization)
- Determined what the previous spend and quantities were on the items (provided how much to leverage)
- Examined the current pricing structure as a reference point to calculate what the end result savings were
- Included in the reverse auction all of Cox Communications' standards (i.e., terms and conditions)
- Provided suppliers with the organization's boilerplate contract to review
- Added questions to the reverse auction that helped evaluate how suppliers would respond if they were awarded the business

Has the perception of the procurement function changed as a result of the reverse auction financial initiative? Hobgood says yes, but not as a result of its reverse auction. Supply managers have to make people understand how the whole procurement process adds value to the bottomline. Once that education begins and supply managers show proof of the value, a reverse auction is just another tool to add to that overall benefit. "Our goal is to put the reverse auction tool on every buyer's desk so that it becomes a standard mold of doing business," says Love. "Ultimately, we believe going forward that it's not only a good tool to help us drive down price but also to control price."

While the proof of the reverse auction's value is not stated in an annual report, the actual savings appear when examining procurement's total capital and its reduction in capital. "Procurement line-item savings are not calculated," says Love. "However, the organization knows the results of our efforts by meeting or exceeding our capital reduction goals."

### **The Leading-Edge Financial Approach**

Not every strategy will be successful for every organization. While many are doing a combination of tactical and strategic activities, few have reached the level of leading-edge. However, for those supply managers and organizations that are going beyond strategic thinking and into more leading-edge strategies, cost reduction opportunities are being realized. The majority of leading-edge strategies involve using the internally developed supply chain to examine organizations outside of their own.

The following are some leading-edge strategies that have been employed:

- Involving supply management in the sales process. In some cases, suppliers are helping one key customer to acquire more business with another of their customers, based on the relationship they already have, or to sell an account together because jointly they have a greater ability to win business for both companies.
- Using the established supply base to choose other suppliers that can help the supply management organization. In many situations, one supplier affects the costs for a second supplier. If these companies do not work well together, the customer pays for it.
- Promoting multiple supply chain tiers to work together vertically and horizontally to impact costs. Not too long ago, Harley Davidson, Honda, BP and several other companies started looking at how their supply base interacted with each other and how this interaction was costing their companies. By working together, total cost can be greatly reduced.
- Holding design competitions. The automobile industry relies on this strategy to choose the best product design for new models. Suppliers will present their concept and the organization chooses the one that best meets its needs in quality and functionality.
- Instituting cost modeling into projects. An agreed upon pricing structure is in place to accommodate any changes to a project that impact cost.

One of the major concerns with early supplier involvement is how supply managers control the cost of a project after locking in a supplier. It is a risk factor that cost modeling can greatly reduce. In the past, organizations would choose the lowest-cost supplier, but if the supplier completed the project as it was originally set up, it would lose money on the job. How did the supplier recoup its losses? It would make its profit from project design changes that would ultimately cost the supply management organization thousands of dollars.

However, for industries such as the automobile industry that have successfully used the cost model strategy, those risks can be controlled. By determining what it actually costs a supplier to produce a part, this figure is used as the standard pricing model. If and when design changes occur, it's not a question of the supplier hiking the price up, but what the cost model is contracted around. Thus, the profit level remains the same, but the supply manager examines what impact the design change will have on the cost to the supplier organization. This is the only change that occurs in the cost. The cost model strategy is certainly something to consider when preparing for the next large-scale project.

There is a tremendous opportunity for supply managers to make a financial impact to their organization and receive credit for their efforts. However, supply managers need the initiative to examine their organization on a larger financial scale than they may have previously been doing. By examining the needs and accountabilities of internal customers, supply managers can best match suppliers that can impact those areas on a total cost basis. While internal customers are imperative to reducing costs, suppliers can offer many cost reduction strategies as well. Every department and supplier is a potential resource and opportunity to make a financial difference in the organization.

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### Leverage Lessons

With all of the strategic and leading-edge financial endeavors that supply management organizations are striving to achieve, the strategies with the potential for the most bottomline impact may be leveraging what already exists. Whether it's in the form of a product or employee, significant savings can be attained by leveraging these two commodity segments. This lesson is taught by two organizations that have benefited by not overlooking these opportunities:

- Cox Communications
- Rockwell Collins

**Cox Communications.** In addition to its reverse auction success, Cox Communications has been able to leverage its spend and drive down millions of dollars in savings through standardization. Sherryl Love, vice president, supply chain management, says this effort is a result of a committee comprised of engineering leads from each system unit, materials management and other segments of the business to establish standardization goals. "We set a goal each year based on what the procurement team believes it can save on commodities and renewals of its blanket orders and master agreements," says Love. She says that procurement will calculate how much it can save on top of the savings attained year over year. Important considerations such as price changes in the precious metals and steel markets are examined before a total estimated savings is calculated. "We've been able to exceed our goals each year, including last year when we exceeded \$20 million just in negotiated cost savings."

**Rockwell Collins.** One of the primary factors behind Rockwell Collins' significant cost reductions, leadtime reductions and quality improvements is its institutionalized strategic thinking. Roger Weiss, vice president of material and supply, says that the company's enterprise sourcing is the leading force to drive Rockwell Collins' commodity teams to engage

procurement and all other internal business units in its sourcing strategies. "While separate groups have separate responsibilities, we've integrated and tied the strategic processes together," he says. "This accomplishment has probably been the biggest feather in our cap as far as success."

Weiss adds that Rockwell Collins, when speaking with every supply management professional and supplier that does business with the company, whether it's at a plant in Melbourne, Florida, Pomona, California or Cedar Rapids, Iowa, will deliver a consistent message: "We come across with one voice." "They are doing business with Rockwell Collins, not necessarily doing business with plant A, plant B, etc., and that's been critical to us," he says. "We believe that's how we get more leverage, that's how we operate as one force in leveraging our company."

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## Leaving No Stone Unturned

Every year it gets more difficult for supply managers to meet the demands of senior management to reduce overall organization expenditures. While strategic endeavors are occurring in most organizations to make a financial impact to the bottomline, there remain opportunities in soft-cost areas that can result in significant cost reductions.

The following are five areas that supply managers should consider exploring when searching for bottomline cost reduction opportunities:

- Internal customer
- Customer service
- Transportation department
- Product life cycle
- Learning-curve considerations

**Internal customer.** The internal customer relationship is a valuable asset for supply managers. Early communication and project involvement with internal customers provides supply management an opportunity to locate quality suppliers for internal customer requirements. Also, marketing the supply function to all of the departments within the organization brings a reduction in "non-purchasing purchases or walk-arounds," duplicated efforts, rush orders and incorrect materials. All of these benefits and reductions translate to cost savings for supply professionals. It calls for some initial tracking of soft costs, but offers a high return on investment in actual savings.

**Customer service.** The customer service department and its heavy interaction with the organization's customer base can have a major impact on future procurement decisions. Customer service representatives often know when customers are considering increasing or reducing orders, discontinuing a product line, expanding a line of product, etc. With such information in their hands, supply managers can renegotiate a contract for better terms, reduce inventory, cancel an open purchase order and reduce potential obsolescence.

**Transportation department.** Collaboration between the supply management and transportation departments can have a great impact on the bottomline. How a material or component is classified on the bill of lading offers a substantial savings in freight costs. Transportation staff also can determine the best routing of shipments and the pickup and drop-off of goods in the same areas, as well as advise on the best type of packaging for a product to prevent the damage of goods. No matter who has to resolve a damage claim, it is

still a cost to the organization in time and may increase safety-stock levels.

It is also important that supply managers stay in close communication with transportation trends, seasonality effects, security initiatives and potential price increases through frequent discussion with in-house transportation staff and trade publications. It makes sense to purchase more inventory prior to a seasonal transportation increase if the carrying costs are far less than the additional transportation increase. This is an excellent example of the trade-offs that make for good business decisions.

**Product life cycle.** It is important for supply managers to understand the life cycle of the product that they purchase raw materials and components for. If a product is in the growth phase, supply management can contract for larger quantities and capture higher-volume discounts. As the product begins its decline, supply management can begin to shut off the spigots. Thus, supply managers would be able to reduce inventory and potential obsolescence.

**Learning-curve considerations.** Another area of cost reduction opportunity is questioning the supplier about how the product cost was evaluated. A supplier that takes on a new production item, assembly or service often figures the cost based on an initial time study. However, per the learning curve principle, labor hours and scrap should go down over time due to experience in making/assembling the product or offering the service. Supply managers may be paying for excess labor hours and excess scrap or waste that are no longer necessary due to gained skill and knowledge.

These strategies represent opportunities to make a financial impact on the organization. It is important that supply management organizations begin searching above the low-hanging fruit and use more strategic endeavors to locate cost reductions. Not only can supply managers at various levels contribute to these strategic financial objectives, but it also leaves no stone unturned.

***Marilyn Gettinger** is president of New Directions Consulting, Cranford, New Jersey.*

## YoURLinks

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