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Make Savings Real — The Secret to Ending the CPO Failure Cycle

The new frontier in finance and procurement collaboration

Who among the following business leaders has the shortest average tenure in their current position?

- A Chief Procurement Officer (CPO)
- Someone in the President's cabinet
- A CFO at a typical Fortune 500 company

If you guessed procurement, you'd almost be right. Among cabinet-level officers in the Obama administration, the average tenure (to date) is less than three years. More important for this analysis (according to CAPs research) is that the average tenure of a first-time CPO in an organization (i.e., those companies establishing the role for the first time) is 3.9 years. The "second" CPO fares even more poorly, with an average tenure of 3.2 years[1].

Comparatively, CFOs (and many other private and public sector executive positions) have significantly greater job security. One recent survey found the average CFO tenure is 12 years, according to Robert Half. This[2] represents an expanding tenure period (from 9 and 8 years compared to previous surveys on the same topic conducted in 2006 and 2000, respectively).

We'll withhold judgment on why recent cabinet appointees tend not to serve out the terms of the presidents they serve. Yet we do have reasoned and researched hypotheses that suggest why CPOs typically hold their jobs for only a few years.

Average CPO comparative longevity points to a series of connected, fundamental problems that directly hinder procurement's ability to impact performance, including:

- Reporting, responsibility, and operational disconnects between procurement leadership and the rest of the executive team
- A limited (procurement) charter that makes it difficult for CPOs to impact budgets; apparent in the typical CPO's inability to fully account for savings in financial planning and reporting
- Limited CPO involvement in annual planning processes and periodic forecasting activities, resulting in a limited ability to impact continued expense management
- An inability to define a consistent, measured means of how Procurement can engage Finance through the course of the procurement process

[1]http://www.ismsv.org/library/johnson2007.pdf

[2]http://rhmr.mediaroom.com/CFOtenure

These problems can disappear if organizations are willing to shift how they view procurement and how they charter CPOs to make a difference. This paper aims to provide an alternative perspective and a new approach for procurement and CPOs to create meaningful and lasting impact on the P&L with full Finance and executive backing. Since the recommendations and "lessons learned" in this paper are structural, they are appropriate to organizations at varying stages of procurement maturity, whether or not they are in the process of a transformation effort or other initiatives. More importantly, the approaches presented require a fundamental "rethink" about how Procurement and Finance together should engage the business to plan for and actively manage expenses while identifying and implementing savings opportunities. There is no middle ground for organizations looking to drive significant value through expense reduction.

Changing the Value Orientation of Procurement

Procurement should develop a new charter that establishes the function as the spend steward and leader in guiding how savings are identified and implemented. At the same time, this charter should complement Finance's role in making the decisions to impact budgets and the financial forecast. This approach requires that Finance leadership remains the steward of the P&L, keeper of the books, and manager of expense ratios. But if Finance "owns" the savings number, what is Procurement's role? Simply put, it's to make things happen as the identifier of savings and manager of spend, which includes managing ratios just as Finance does.

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This type of thinking may seem radical. In the past decade, there has been an overemphasis on processes and technology for procurement spend visibility, P2P automation, negotiation, and even recently, risk management. But there has also been a lack of insights and emphasis on how to impact an actual P&L based on procurement efforts — something that should come first and is a fundamental aspect of savings realization and enabling CPO effectiveness and longevity.

Contrary to common thinking, Finance and Procurement collaboration is not about setting A/P invoice tolerances. An overemphasis on technology has degraded focus on driving the desired types of visibility at the intersection of Procurement, Finance, and the rest of the business. Moreover, no established technology providers have targeted this area. Spend analysis, ERP, business intelligence (BI) vendors have simply confused this goal by positioning technology as the solution and not part of the solution.

A new common ground is required, where Finance prescribes continuous budgetary improvement and savings targets, chartering Procurement to work with the business to achieve them. Using this approach, a CFO might give a cost reduction target for external spend (e.g. 5% across typical budget line items that include IT, Marketing, and Professional Services), promptly reflects it in budgets. It is then Procurement's responsibility to identify the leading means to implement this target while working hand-in-hand with the business, effectively becoming the tool to implement the targets in conjunction with the business and not at odds with them.

Sound easy? Conceptually, it is. Implementation is what can be vexing for organizations that refuse to leave the old procurement mindset and address the core problem.

Building Budgets Right: Procurement, Finance, and More Effective Planning

If Procurement has an integral executive seat at the table for all financial planning and budgeting meetings, then much of this paper will be a refresher (hopefully with a few new helpful hints). For everyone else, it will be eye opening. When Procurement is detached from planning and budgeting, the challenge is measurement.

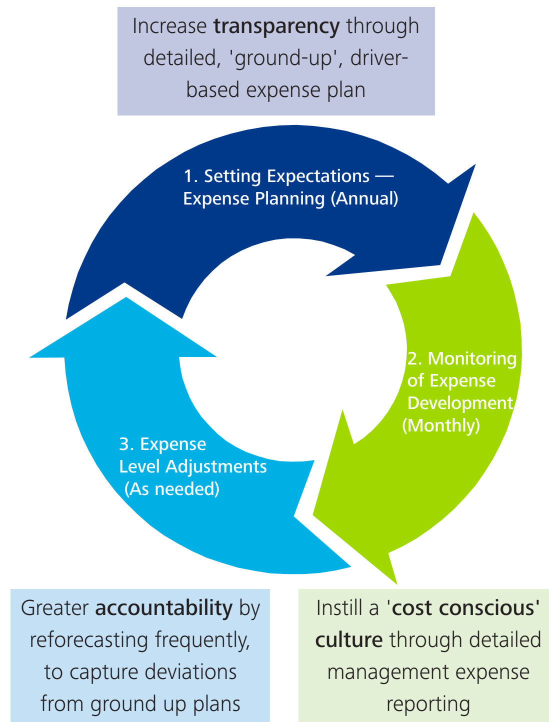
Historically, when Procurement is not in synch with Finance, our experience shows that plans are set by simply rolling forward many budget line items, with a limited ground-up view on external spend categories, e.g. travel. There is typically a disconnect between the drivers of the spend and the actual planned expense. Furthermore, effectiveness is measured in "soft" ways such as spend reduction, cost avoidance, and reduced PPV with limited visibility and traceability to the company's financial statements.

The root cause of these typical outcomes stems from Procurement not working with Finance to define, on a ground-up basis, transparent budgets, built based on the underlying drivers of the expense, e.g. average prior year trip costs, expected volume by department, for travel budgets. In many cases, Procurement has the data and insight to define many of the external pricing drivers and to forecast the types of savings (and demand management considerations) that are possible. Yet what typically happens in the planning process is a plus — or more rarely, a minus — tweak to the annual budget, rather than a ground-up analysis leading to fundamental changes in the budget and plan.

In many cases, the culprit is a failure to align incentives and metrics. Finance and line of business owners are really measured on a singular metric for initiatives: "P&L impact." Yet Procurement is not. The disconnect between soft and shareholder-driven measurement has robbed Procurement of the ability to make a big enough impact. After all, "savings" alone is an inadequate measurement. But if a procurement view into savings can cascade to real, measurable metrics such as impact from cash to P&L, impact by category, business unit, etc. — during the stages of the process, starting with budgeting — the results can be significant.

As part of this consideration, procurement cannot be about "saving" things that were not in the budget in the first place, and the solution here is elegant and simple. First, Procurement and Finance should consider collaboratively setting transparent budgets based on up-front category analysis and planning. Second, they should monitor actual expenses against these ground-up budgets. Third, they should work together to drive savings and targets through an iterative and compliant forecasting process. Together, this adds up to a recipe for the secret sauce to drive CPO longevity!

Dynamic expense Management Cycle



Yet moving to this model can represent a significant challenge, because organizations often still manage with mis-incentives and a lack of transparency. For example, when Procurement proposes savings of $20MM out of the budget but don't have transparency into how it was budgeted originally, even if they do a better job, they may get limited credit for their programs.

Further, consider an organization that bought 5,000 laptops last year but 10,000 this year. Yes, the overall spend went up even if lower unit cost were attained based on negotiations. But as procurement is historically measured, while there might be savings on a unit cost basis, there is a negative (or maybe a slightly positive) P&L impact, despite the effective sourcing work.

And Procurement is not in a position to fully explain what happened! An explanation in finance terms: e.g., "if not for these savings efforts, this is what you would have spent, and you would have been surprised at a negative variance in the balance of this," is required. Sourcing 'savings' tend to only make matters (and trust) worse. For example, sourcing reports may show a downward purchase price variance (PPV) variance (i.e., "sourcing savings") based on an existing program such as meeting a volume discount threshold and then having procurement take credit for creating new savings which infrequently materialize from a true budget impact perspective.

This repetitive tragic comedy is the underlying reason why cost avoidance and generalized "savings" do not show up in financials. They are instead used synonymously with soft, made-up numbers that have no bearing on actual business performance. Apples-to-apples incentive alignment is required, which brings us to the prescription for savings realization.

Three Tenets of Savings Realization

There are three tenets (that should be implemented together) to enable savings realization through P&L and procurement metrics alignment. These are:

1. Getting Finance involved early and having them be a part of cross functional category or sourcing team well before actual sourcing or demand management action is taken
2. Having the CEO/CFO set large savings targets and mandate for change
3. Impacting budgets up-front to show stakeholders in the organization that 'this is indeed different from prior efforts'

We will explore each of these in more detail, beginning with getting Finance involved as early as possible in defining opportunities. The **first element**, and the top priority, is to have Finance sign off on cost baselines as early as possible. Then, if relevant, Finance should also sign off on the total cost models (e.g., inventory carrying costs, raw materials, based on category) associated with a given spend. Next, Finance and Procurement should work together to prescribe the GL code impact that savings will have. This should take the form of developing calculations and pro-forma analyses of how savings will flow into financials, capitalization, amortization, etc. Once the facts are put together, Finance and Procurement can jointly proceed to the next step.

The **second element** is that top-down mandates (which procurement ideally helped drive), ought to be driven jointly by the CEO and CFO. After which, it is the responsibility of Procurement to work with the business to figure out how better to archive the targets. In other words, if Finance's job is to "impact the numbers" it is Procurement's job to "figure out how to make it happen."

With these baselines, cost models, and the savings implementation process in hand, Finance and Procurement can move to the **third element** — setting what might appear to be audacious savings target, with reduced budgets based on the target, before a sourcing process begins. The operative element here is before a sourcing effort. By reducing a group's budget rapidly, encourages — or requires — their participation in the sourcing process. If they don't participate, they will have to reduce costs elsewhere.

A lesson in budget reductions and sourcing targets is not to suffer from the fate of slow, incremental change. CFOs and CPOs alike should consider that to drive P&L impact, it is essential to get everyone's attention. It is a leading practice at this stage to take a significant amount out of the budget; the larger the amount swept out upfront, the greater the incentive to participate in the process. Of course, if the specified level of savings does not materialize (e.g., from rising commodity prices or reduced demand) at the end of a sourcing or related cost reduction initiative, a "true-up" can be done on the category (and forecast).

In implementing such a program, it is essential to factor into account the following considerations:

- During the savings identification and budgeting process, there should be continuous linkage between Procurement and Finance
- Finance, Procurement and line-of-business/business unit stakeholders ideally work together "arm-in-arm" rather than "throwing things over the fence," which often categorizes Procurement's relationship with Finance and the business in implementing savings
- Moving away from a PPV "old price vs. new price" centric approach as early in the process as possible is important to determine that savings are easily implementable and will drive to the new budget requirements
- Replace the unit-cost-only notion with a total cost calculation based on a variety of factors: unit cost, demand management, working capital, etc. The underlying reason is that monitoring policies and procedures introduces significant complexity, which is why Finance should challenge assumptions and keep moving forward
- It's easier react to a big target (upfront) and critique it versus trying to achieve 'buy-in'after a sourcing process is complete or in progress. Cohesive teams tend to work towards a goal (even an audacious one). Take the leading-effort budgeting initiative up-front and correct later if needed

Help wanted: Visionary CFOs and Effective CPOs

The combination of visionary and effective CPOs begets the type of collaboration that can lead to breakthrough performance. Organizations should take the following points into account:

- Only CFOs can establish the trust factor and initially "stick their neck out," as CPOs often lack sufficient rapport across the organization. Effectiveness requires the combination of the two executives to step out and impact plan and budgets
- While a strong CPO is essential, it is the CFO who can put things in the applicable terms to the board and the business. For example, "I need the divisions to get the expense ratio back to where it was." The CFO should also put procurement savings in the context of other business constraints; e.g., "reduced top-line revenue growth is driving our cost reduction efforts."
- Even with a strong CFO, a "beaten up CPO" will resist the approach outlined in this analysis; leadership in procurement is essential
- CPOs should view their role as the 'steward of spend' and not only as the lead 'deal negotiator'; if the CPO only talks about how the last 'deal' was done, you may not have the required leadership in procurement

This approach is not incremental. It requires a CFO who is willing to not only participate, but to also help drive a broader transformation with Procurement serving as the business partner responsible for implementing a broad-based strategy set forth by the top leadership of the organization. Equally, it is about realizing that Procurement (alone) rarely has the skill sets/rapport to fully engage the business without CFO leadership.

Go Forth and Budget Right

The perspectives outlined in this analysis can fundamentally change the value Procurement and CPOs can provide for organizations. But they require a "rethink" on what is truly the role of Procurement and how it collaborates with the business.

Such an analysis will change how effective procurement leaders need to think about their overall charter and role.

While some may find that the suggestions require too much change at once, our experience suggests that they will appeal to leaders who are capable of making a transition to a new type of organization model that rewards a finance/procurement alliance, risk taking ("nothing ventured, nothing earned") and the true spirit of collaboration with the rest of the business; ultimately focused on generating shareholder value. And importantly, Procurement should be at the table for the entire planning process to help accomplish these goals.

Too often, as we have covered throughout this analysis, execution trouble comes from a disconnect with translating identified procurement savings to actual impact. Budgets will frequently be imperfect. But when Procurement does not know how Finance builds a budget, it is impossible to even hold a conversation about the right (or wrong) ways to go about identifying and implementing savings opportunities. Inserting Procurement front and center at the budgeting table is an essential element of furthering CPO longevity, Procurement's influence and standing, and generating significant year over year shareholder value that most organizations are looking for.

Turning concepts into action

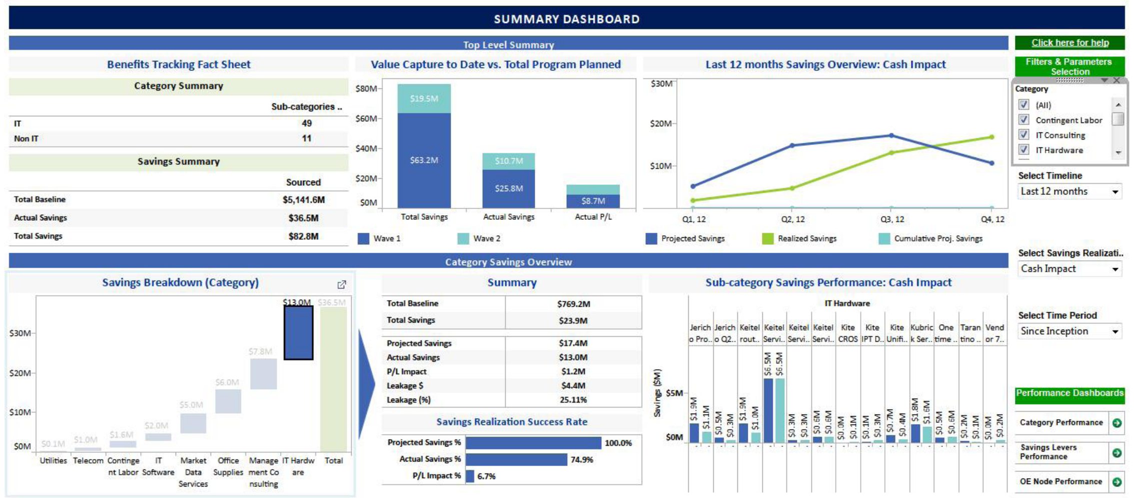
Reporting relationships do not necessarily matter as much as one might think. Granted, if the CPO is a direct report to the CFO, the approach we have explored is easier. But if a CPO reports to a COO or other executive, the process can serve to elevate the role of Procurement (and the ranking executive in Procurement) by enabling the function to act as a peer to Finance based on its ability to provide insights and outcomes to finance requirements (i.e., driving savings based on a new budget).

Our Take: Turning Savings Data and Information into Action and Results

Truly the 'rubber meets the road' on finance and procurement collaboration when demonstrating that the saves are real and that they are hitting the P&L. The best processes and governance can still fall short if the 'proof' can't be visualized and effectively shared with the key personas (i.e. stakeholders). It is Deloitte's experience that analytics and advanced data visualization should be deployed in order to enable savings realization, providing a granular view to what is driving savings for a category/commodity, what is driving variances to expected results, and ultimately providing a granular enough view to allow the key personas to take action to make sure the savings are real.

Many of our clients have struggled with this concept for years, often times citing poor data/lack of data availability as internal systems and data sources alone aren't sufficient. Our perspective is that poor data/lack of data availability are constraints that should be worked around in a pragmatic way. Deloitte has developed proprietary processes, tools, and analytic enabled technologies that help our clients move past this barrier and build the type of collaboration and bottom line results referred to in this paper.

Below find snapshots of Deloitte's proprietary tool that has been custom built for key personas that play critical roles in the savings realization process: CFO, CPO, Category Managers, BU/LOB Finance, etc. The visualization and access to granular information is key, regardless of the technology, in order to enable the persona to take action.



Implementing the Approach: Category Exploration

On a category level, specific tactics can vary slightly depending on type of spend (e.g., direct, indirect, services) as well as the type of buying activity. To illustrate this, we will test different category examples in IT hardware, contingent labor, and metals.

IT Hardware (G&A)

When developing an approach for IT hardware (e.g., laptops), Procurement and Finance ought to determine spend baselines and engage the business to understand the potential levers and actions that are possible to drive savings — and what is explicitly (if anything) off the table. This involves sitting down with business owners/IT and understanding their actual requirements (not just specified hardware by SKU).

Based on this engagement approach (plus defining baseline requirements and modifications that are required, like launching a new office that requires a capital expenditure for IT spend), it's possible to understand estimated growth plans from year to year. Further, by tying this into the possible tactics upfront and conceptually pushing participants to consider available options (e.g., the use of a tablet and a desktop vs. a high-powered notebook), it is possible to build inputs to a savings model exploring multiple strategies.

With this information in hand, Procurement can take a leadership role in working with stakeholders to rationalize demand specifications based on specific end-user requirements, having stakeholders sign off and getting full organizational support (with Finance's backing, if needed) to explore as many opportunities as possible. Then it comes time to have Finance sign off on the baselines, specifications and changes along with remaining business stakeholders. Getting Finance to say, "I agree" with the program (including demand rationalization and specification) is important.

Then, Procurement is able to use Finance as a lever to tell a particular IT holdout, for example, that the specification they are asking for is not worth the added cost based on the business value. This puts Finance in the role of saying no, not Procurement. In short, it moves the justification and onus from Procurement to Finance, with Procurement as the intermediary tasked with understanding both sides and making recommendations. With Finance and the IT organization signed off on the new specifications, a traditional sourcing process can follow, ideally one exploring multiple options and encouraging supplier creativity in meeting desired outcomes and bidding rigid specifications.

Contingent Labor

Budgeting, Finance, and HR engagement for contingent labor follows a similar process as IT, but specific tactics and metrics used to convince folks can be different. For example, it is essential to establish baseline costs, determining actual business requirements, and potential labor and related components for Procurement and Finance to collectively understand mark-up costs, decoupling opportunities, costs for testing/screening/tax, processing efficiency opportunities through leveraging a vendor management system (VMS) or managed services provider (MSP). Additional metrics and KPIs might include appropriate rates by geography, furloughs, conversion, etc.

Exploring needed requirements and existing performance (compared with business requirements) can streamline the process of getting HR and hiring managers to sign off on baselines and requirements. This forces HR to then explain "why not" to specific options that rely on benchmark elements and job descriptions. Finance and HR can then sign off on baseline calculations and final requirements.

Following a sourcing exercise, Procurement can lead ongoing supplier management and evaluation, track benefits, make sure benefits are ramping and occurring, and determine overall compliance (e.g., that people are following and hiring for the applicable job classifications). For contingent labor (and other categories), Procurement's job, post award, is to evaluate savings rather than conduct a higher-level "scan."

At the end of the initial savings implementation/ stabilization period, Procurement should work with Finance so that savings are in the budget plan. If savings are not materializing, it is important to understand why. Has demand changed? Is the supplier billing at the wrong price? These are the types of questions that both Procurement and Finance ought to ask of each other — and HR.

Metals

Impacting budgeting for direct spend categories (such as metals) is largely dependent on the up-front goals and strategy of the business. One of the first things to understand is the desired outcome of what the procurement organization and line of business owners want to achieve within the category. Cost savings? Risk mitigation? Is the organization concerned about margins based on raw material costs — or can they pass through costs directly to customers? Procurement teams will deploy different strategies working with finance based on answering this question.

Moreover, Procurement should consider first deploy total cost modeling to understand the total impact of material vs. value-added costs. For companies focused on reducing budgets based on savings targets tied to raw material prices, one of the next tactics should center on building forecasting models to understand where the organization believes the price of underlying raw materials are headed. As part of this effort, Procurement can work with Finance to model scenarios around the impact of cost structures based on forecast models. For organizations buying or producing parts, sub-assemblies or assemblies, it is essential to assess what the team believes the forecast scenarios (low, average, and high cases) are going to be and to model the impact on total cost for those components and parts.

If the raw material/metals portion of the costs for a given category are 20-25% or more of the finished costs, and, assuming the spend is substantial, organizations will likely want to develop budgets based on more proactive strategies, such as buying forward or hedging, especially in flat or rising markets. This also holds if the organization wants to lock-in margin. However, if a forecast scenario calls for a falling market, budgets should be based on timing orders and buying on the spot market. In addition, by tying buy/sell agreements to price indexes, it becomes possible to create budgeting and forecast transparency through to contracts, invoicing, and payment.

Other levers to test in the budgeting process to forecast savings include scrap and tolling programs, including the opportunity to take back margin points from suppliers selling scrap (from underlying raw material that the buying organization purchased). On a more macro level, Procurement and Finance can work together in the budgeting and planning phase to consider the cost modeling impact of re-shoring and near-shoring decisions as well, based on changes to raw material costs, inventory, logistics, tax, tariff, duties, etc. The importance of all of these efforts, of course, is to impact the budget based on planning and forecasting efforts that drive to working hypotheses based on forward costs.

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