CLOSING THE GAP BETWEEN CLAIMED AND REAL SAVINGS ON INDIRECT SPENDING

Complimentary Research

Management Issue

For Current Members of Hackett Executive Advisory Programs

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EXECUTIVE SUMMARY

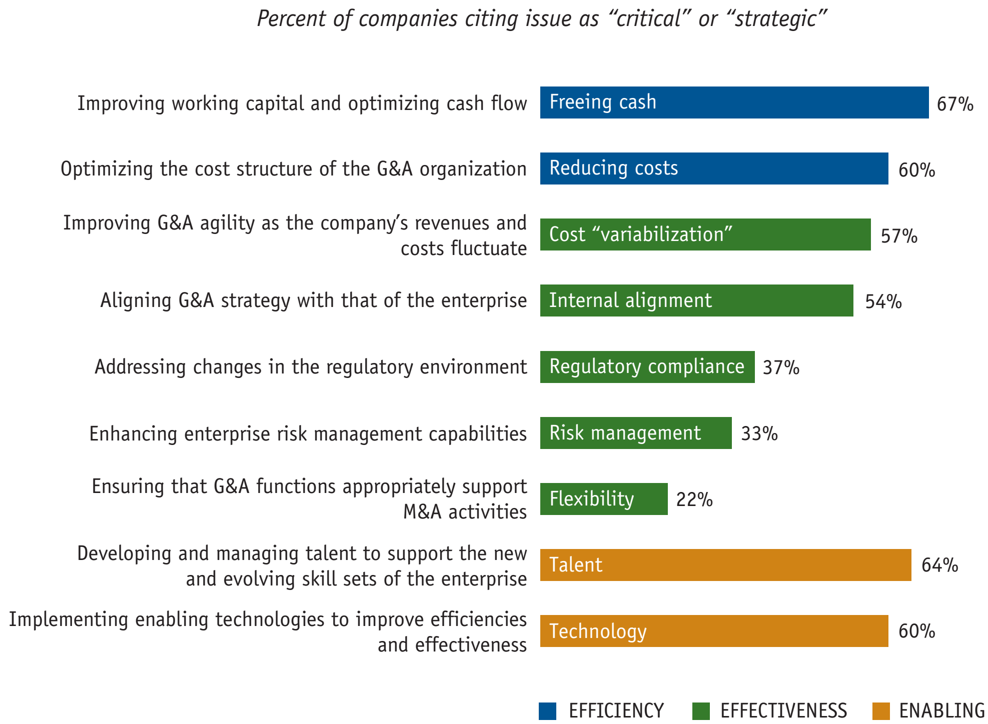
In an environment of uncertainty and economic volatility, it is paramount that the finance function have the ability to track non-core, or indirect, costs and document savings on these expenditures. The reason finance executives should care about measuring savings on non-core, or indirect, expenditures goes beyond the fact that they can equal 15%-40% of company revenue. The Hackett Group has found that companies capable of tracking realized savings as they occur, as opposed to booking the savings promised at the time supplier contracts are negotiated, see 71% higher actual savings. The problem is that measuring savings on indirect spending is deceptively difficult. Achieving savings visibility requires a combination of technology, process and expertise and deep collaboration with the procurement organization.

INTRODUCTION

In an environment of uncertainty and volatility, finance executives are focused on freeing cash and reducing costs, as well as maximizing business agility **(Fig. 1)** and improving the predictability with which they plan and execute. Doing so requires paying close attention to strategic priorities like innovation, profitable growth, and a clear line-of-sight on cash and costs.

The costs that are the subject of this research are the non-payroll-related expenditures disbursed to suppliers – exclusive of direct materials costs. Also known as "indirect spend" or "non-core spend," these expenditures usually run in the range of 15%-40% of revenue. It may be slightly lower for some manufacturers and retailers, and much higher for many services companies. This is partly why most procurement organizations, which often report to finance, have teams focused exclusively on managing indirect spend. Using "strategic sourcing" processes to reduce purchased costs by 15% on indirect spending that averages 15% of revenue equates to 2.25% annual savings (as a percentage of revenue). In theory, this is an opportunity that should fall to the bottom line. The problem, though, is that theory is not always reality, especially in the world of non-core spending.

FIG. 1 Cash and cost: The top finance performance priorities in 2010



Source: The Hackett Group 2010 Key Issues Study

Finding the Lost Savings in Indirect Spend

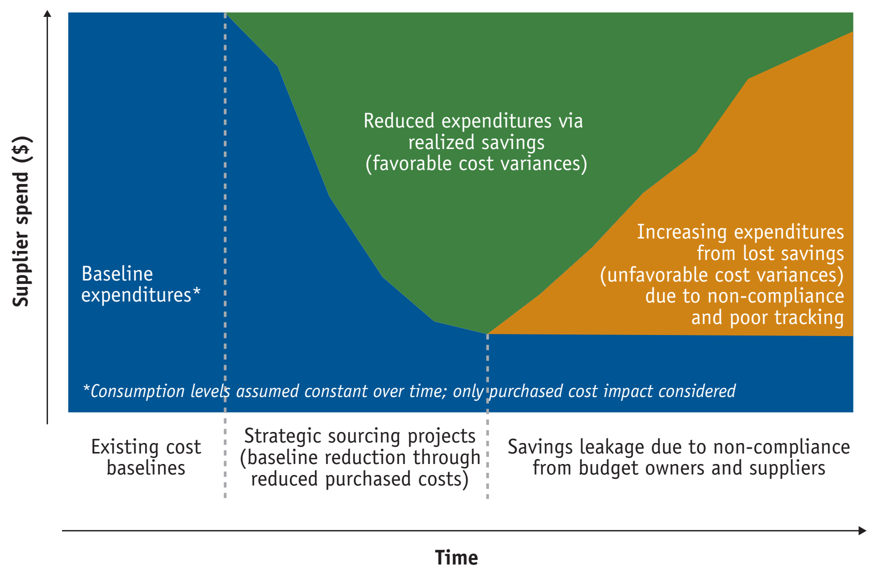
Roughly 70% of large organizations track and book identified savings (savings created at the point of a negotiated supplier agreement) – not realized savings (achieved at the point of spending as those savings actually accrue). While tracking realized savings from headcount reductions and from price reductions in raw materials via PPV (Purchase Price Variance) tracking is relatively straightforward, indirect expenditures present a different set of challenges for management, especially for controllers and internal-audit leaders.

Unlike direct spend, indirect spend is highly fragmented across the enterprise and buried within a multitude of contracts, budgets and cost centers. This creates a problem for the finance organization that wants to ensure that the negotiated savings claimed by procurement are indeed hitting the bottom line. Without systematic and reliable savings visibility, these savings are easily "lost."

"Maverick spending" (i.e., spending that bypasses corporate agreements with preferred suppliers) and supplier non-compliance to negotiated terms and pricing erode the value identified and claimed by procurement. Based on The Hackett Group's benchmark and performance study data, the average maverick spending rate of 14.4%, when applied against the 15% indirect spend savings rate cited previously, means companies are forfeiting $21.6 million per billion in non-core spending. Of course, individual results will vary based on amount of spending, savings potential, current level of control, and other factors.

While finance can always reduce budgets by the negotiated savings amount, this is merely "forced consumption reduction" if the costs are not truly being removed from the system via the utilization of preferred vendor contracts **(Fig. 2)**.

FIG. 2 Even the best supplier contracts ring hollow if identified savings are not realized and tracked over the long term

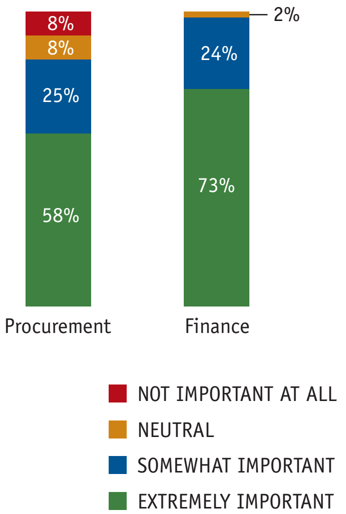


Source: The Hackett Group

In early 2010, The Hackett Group conducted a research study[1] to assess the impact of poor savings visibility (and associated spend visibility) on both the magnitude and predictability of savings. We gathered 76 qualified responses from finance and procurement functions with average third-party expenditures of $5.4 billion ($3.1 billion of which was comprised of indirect expenditures). Companies in the top quartile in indirect spend savings performance were designated as "top performers." The remaining participants were classified as the "peer group." Finally, we analyzed all participants' capabilities in savings visibility and spend visibility and correlated these to savings performance in order to determine which capabilities were empirically impacting savings performance **(Fig. 3)**.

[1] The Hackett Group Finance Spend and Savings Visibility Study, 2010

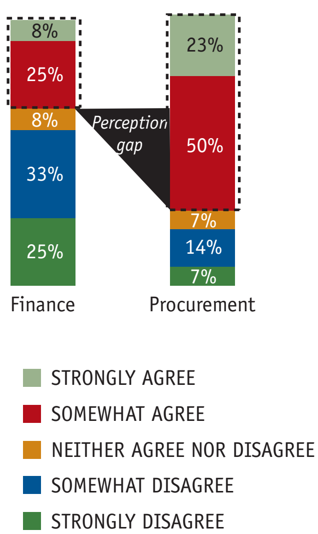
FIG. 4 Finance and procurement agree on the importance of tracking realized savings for indirect expenditures



Source: The Hackett Group Spend/Savings Visibility Study, 2010

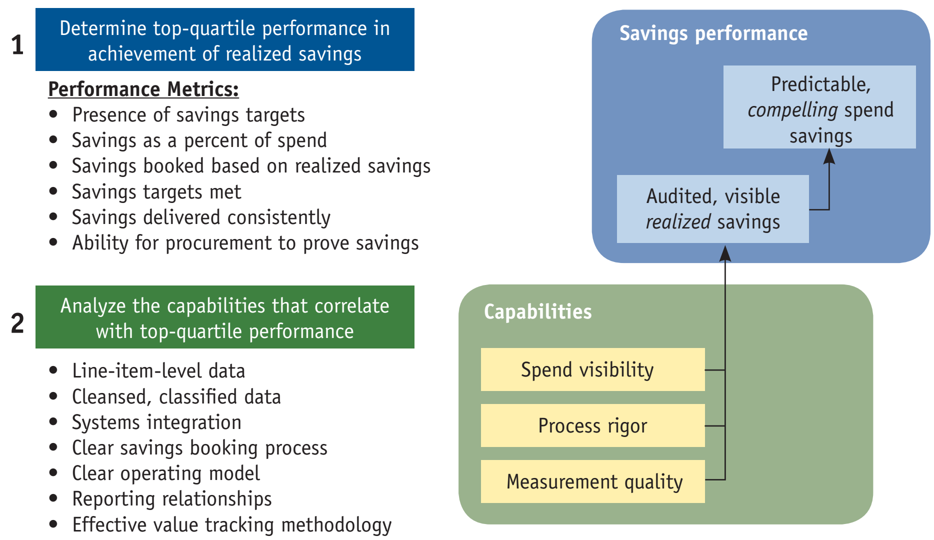
FIG. 5 There is a perception gap between finance and procurement regarding the level of visibility of actual vs. negotiated savings

"The savings claimed by procurement on indirect purchases are falling to the bottom line and can be proved"



Source: The Hackett Group Spend/Savings Visibility Study, 2010

FIG. 3 Correlating savings tracking capabilities to savings performance



Source: The Hackett Group

Indirect savings performance

Before discussing capabilities, let's take a quick look at our definition of savings performance. In indirect savings performance, top performers bested the peer group in a variety of areas:

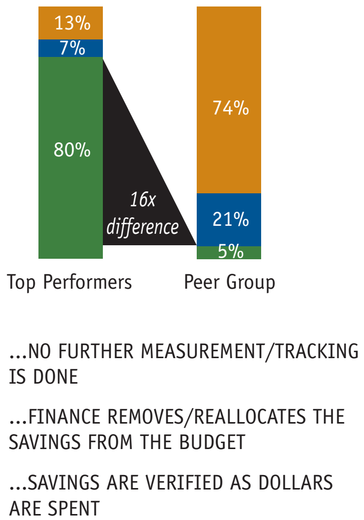
- Top performers achieved 6.43% annual indirect spending savings as a percent of total indirect spend, vs. 3.85% for the peer group.
- 73% of top performers exceeded their indirect spend savings targets, compared to 51% of companies in the peer group.
- 87% of top performers agreed that procurement consistently delivers savings to the bottom line, compared to 40% of the peer group.

These are compelling differences, but let's more closely examine savings visibility and the supporting capabilities that deliver top performance, especially from a finance and procurement viewpoint. There is no disagreement between the two regarding the importance of savings visibility. Indeed, finance rates it even higher than procurement does **(Fig. 4)**. Also, every top performer ranked it as extremely important, and it seems that a bias towards measurement and visibility is critical to delivering results. Yet, while the two business functions agree on the importance of savings visibility, they are much less aligned regarding procurement's effectiveness and ability to provide visibility to the actual savings hitting the P&L **(Fig. 5)**.

While the study could not validate actual savings visibility at each firm, it is fair to say that there is at least a perception gap between finance and procurement and therefore an opportunity for both groups to get on the same page regarding requirements, performance, capabilities and gaps to be closed.

FIG. 6 The greatest gap is in the capability of verifying savings as spending occurs

"Savings are considered booked/ achieved when they are negotiated and agreed to by the supplier and …"



Source: The Hackett Group Spend/Savings Visibility Study, 2010

Capabilities That Improve Savings Visibility

The study results highlighted three key areas of capability required to optimize visibility of realized savings across the enterprise:

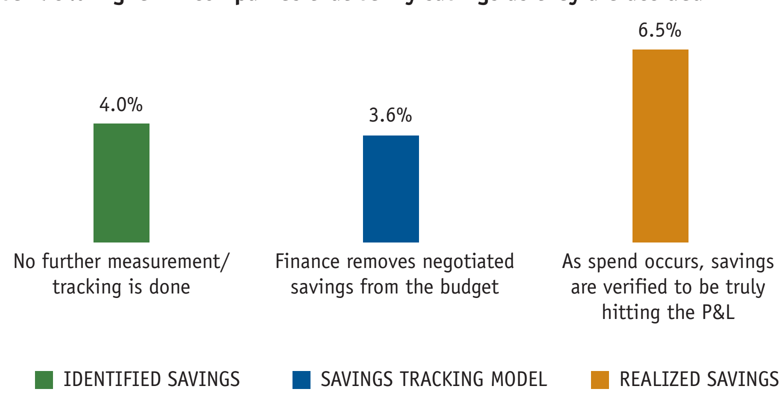
1. Clarity of operating model and process

A recurring theme in the study findings was that top performers consider building and aligning these capabilities a shared responsibility between finance and procurement. Top performers are distinguished by their ability to verify savings as dollars are spent. Eighty percent of top performers are required to do so, compared to only 5% of the peer group **(Fig. 6)**. Within the peer group, 74% of respondents did not verify the realized savings, owing to many factors:

- Procurement only serves as a negotiator, and has not taken on a broader role in consumption management, demand planning, compliance monitoring, supplier innovation, or related activities. Once deals are negotiated, it is the business that decides whether to accept them.
- Since procurement is often narrowly measured by finance on price savings achieved, it focuses on making new deals, rather than taking a life-cycle view of the supplier and total cost of ownership (TCO).
- The company lacks the tools and time required to properly manage data needed to measure and report on savings.

Additionally, 7% of top performers and 21% of the peer group indicate that merely reducing budgets in the amount of the negotiated savings serves as an effective tracking system. However the reality is that, while this approach might reduce total dollars spent, if unit purchased costs are not actually reduced, savings are delivered by "forced consumption reduction," and finance certainly doesn't need procurement's help for that. This creates a vicious cycle. Viewed only as budget reducers and not as partners in the long-term quest to do more with less, procurement will likely find itself shut out of budget owners' buying process. This may be one reason why the companies that use this savings booking method achieve only about half the savings as those that book savings only as they are accrued **(Fig. 7)**.

FIG. 7 Annual indirect spend savings as a percent of total indirect spend is over 70% higher in companies that verify savings as they are accrued



Source: The Hackett Group Spend/Savings Visibility Study, 2010

Top performers unanimously agree that the process they use for identifying, tracking and booking purchased cost savings is both clear and consistently followed. This compares to 61% of the peer group. Ninety percent of top performers specify who is accountable for validating savings. Procurement and finance might have to jointly sign off on the findings; a separate internal audit group might have sole responsibility; or a procurement/supply chain management group within finance might be designated. In contrast, only 60% the peer group assign responsibility.

There is no single "right" way to improve savings visibility, but when finance and procurement processes and responsibilities are misaligned, opportunities are lost.

2. Spend visibility and data quality

There are two major types of information needed to enable savings visibility:

- Savings reporting built on an infrastructure of detailed spend analysis and reporting.
- Master data that stores the cost models (since roughly two-thirds of indirect spending is on services) which ultimately drive the spend analysis results.

The basic objective of spend visibility is to know how much budget holders are spending, on what, and with whom. In the study responses, 93% of finance executives and 80% of procurement executives agreed with the following statement: "My organization needs better visibility of indirect purchase expenditures." This is understandable, as most organizations realize the importance of spend visibility in supporting high-impact strategic sourcing processes that help aggregate spending power and reduce purchased costs.

> "Although we have a fully integrated ERP system, the granularity of the data is not as strong as I would have hoped for."
>
> - Finance participant, discussing spend visibility

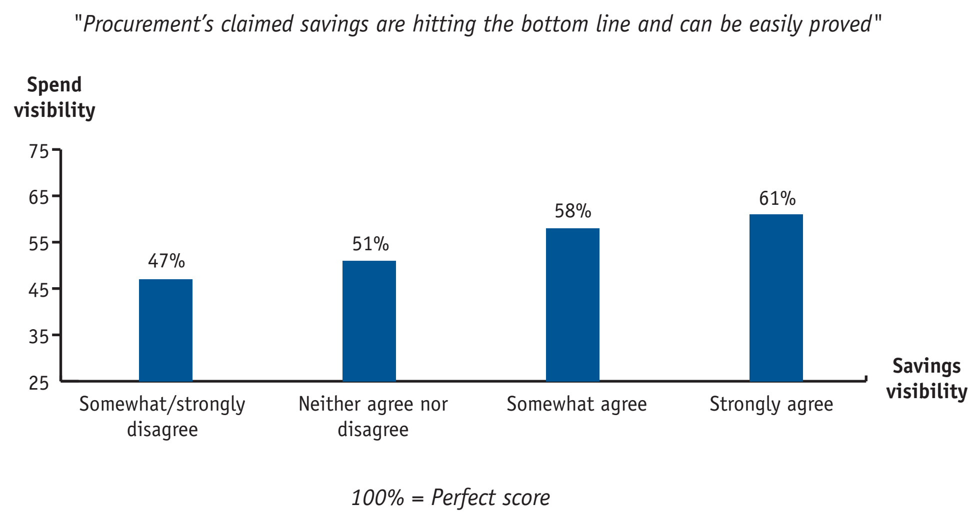
While the problem is very clear, the solution is actually surprisingly difficult and complex. Periodic aggregation of accounts payable (AP) and purchasing history into a data warehouse, followed by a data-cleansing and enriching process to provide basic "spent analysis" (spend by cost center as well as by supply market "commodity" categories) is a painful, laborious process for most. Companies tend to do these data refreshes monthly or quarterly, and it takes at least four person-days in finance or procurement, not to mention the IT effort and expense, per refresh.

Hackett's procurement benchmark database shows that highly paid sourcing staff spend approximately half of their spend-analysis effort wrangling spending data (e.g., aggregating, cleansing, de-duplicating, classifying, enriching, cross-referencing), rather than analyzing it. For many, the problem is a lack of the technology that can aggregate spend data from multiple source systems, cleanse and accurately classify it. The resource-intensive, manual alternative leads to infrequent refreshes of spend analysis. This in turn creates delays in obtaining accurate, actionable spend information.

But even after all the work required, spend analysis is not completely sufficient to help budget owners pinpoint where opportunities are being lost through non-compliant spending. Only when visibility to this activity is achieved can such non-compliant consumption be curbed.

The study results also highlight a statistically significant correlation between spend visibility and savings visibility **(Fig. 8)**. In general, the higher the spend visibility,

FIG. 8 The level of savings visibility rises with the level of spend visibility

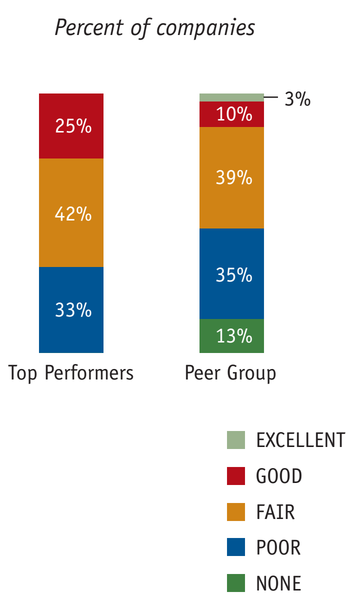


Source: The Hackett Group Spend/Savings Visibility Study, 2010

the higher the savings visibility. Still, spend visibility is not perfectly correlated with savings visibility. Some companies have good spend visibility but poor savings visibility, which gives them a good foundation to build upon. Other companies have poor spend visibility yet claim high savings visibility. This group is likely to be ill-prepared to defend its savings data and probably spends a lot of time reconciling spreadsheets to the actual financials in the ERP system.

The biggest technology barrier to savings visibility involves reliable, high-quality master data for cost tracking. In most companies, multiple, non-integrated systems track different categories of spending, often in different geographies. Further, there is frequently insufficient detail available across systems to quantify cost baselines. Indeed, only 13% of the peer group members characterize their systems as "good" or "excellent" for capturing and tracking cost baselines for the purpose of measuring realized savings **(Fig. 9)**. At 25%, top performers are not much better off.

FIG. 9 Quality of system of record for capturing and tracking cost baselines electronically



Source: The Hackett Group Spend/Savings Visibility Study, 2010

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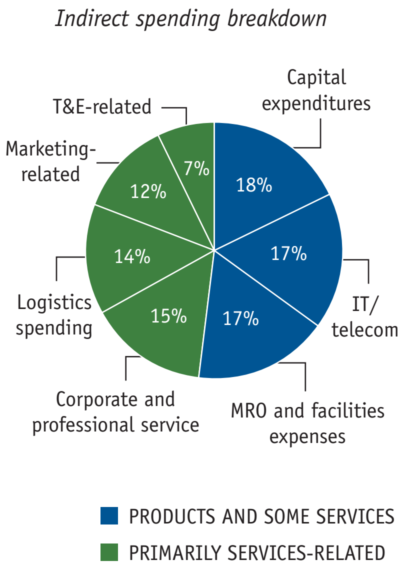
FIG. 10 Most of companies' indirect expenditures are services-related



Source: The Hackett Group Spend/Savings Visibility Study, 2010

"I've found that while it is OK to debate savings targets with stakeholders, you better not be debating the metric definitions and calculations – that needs to be done upfront"

- Chief Procurement Officer of a large health care company

Why the gap? ERP systems and eProcurement systems are not designed to model the detailed cost elements and commercial complexities associated with many types of services spending (and thus savings). These systems usually only capture detailed information on catalog-type items and, perhaps, some basic rate cards for some services. For the broader landscape of purchased services from specialized contractors, large consulting firms, outsourcing providers, logistics firms, etc., the tracking of savings is a more complex affair. Yet this type of spending makes up nearly two-thirds of indirect expenditures **(Fig. 10)**.

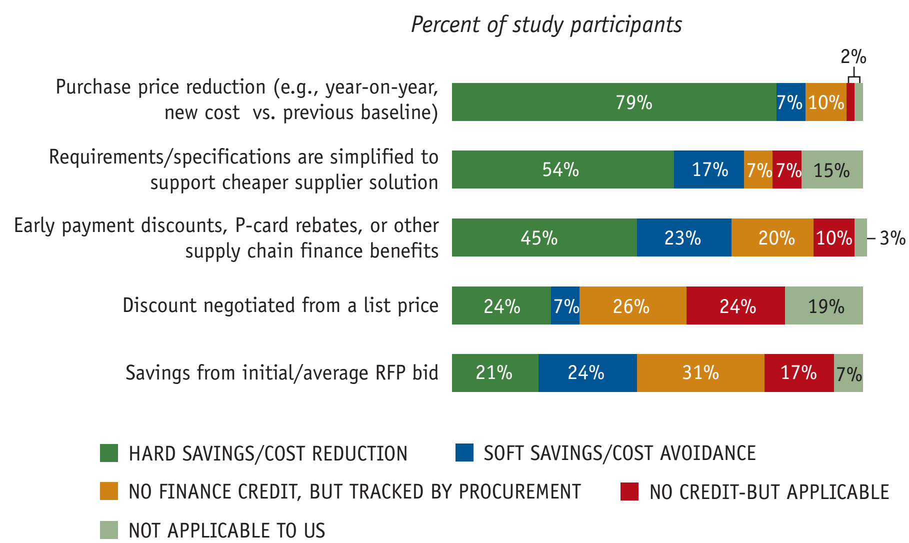
3. Precise savings calculations

At first glance, the savings definitions related to non-core expenditures seem straightforward, but in reality there are many complexities. For example: *What is allowed as the cost baseline? How long will savings be allowed? Does cost avoidance count toward savings goals?*

In the procurement version of the study, we examined 18 unique supply-related value streams, and to what extent each value stream was "counted" by finance and by procurement. **Fig. 11** shows five types of purchased cost savings that are based on an incremental improvement to a previous baseline.[2]

Since there is so much variation in how companies track these benefits, it is critical that companies have clear accountability and definitions for each.[3]

FIG. 11 Level of credit given to various spend-cost reductions



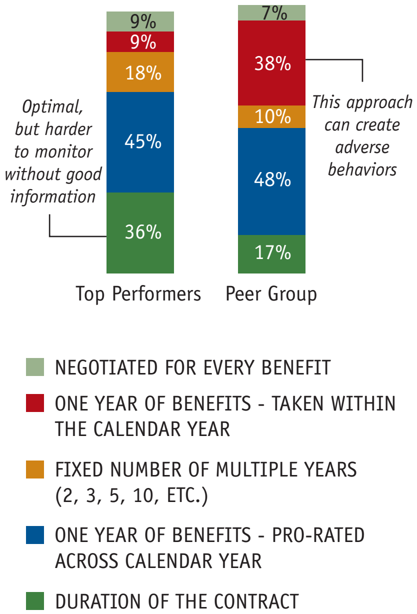
Source: The Hackett Group Spend/Savings Visibility Study, 2010

[2] We also capture two value streams related to price hedging and comparing pricing to market indices, but won't dive into that topic here.

[3] For more information on the Procurement Value Measurement Study or for the full definition of spend cost reduction used by The Hackett Group, please contact the authors.

FIG. 12 Procurement and finance must become better aligned on detailed savings assumptions

'When calculating sourcing benefits, how long does finance usually allow procurement to take credit?'



Source: The Hackett Group Spend/Savings Visibility Study, 2010

Even in the single most commonly used metric, purchase price reduction, there is a great deal of variation. For example, how long will benefits be allowed? One year? For the duration of the contract? In perpetuity? **Fig. 12** shows the disparity from company to company in this measurement, and the somewhat better choices made by top performers.

Top performers tend not to recognize benefits only within a calendar year (like a sales representative's commission). Top performers either prorate the savings across multiple periods or for the contract duration, theoretically a better choice, but harder to track.

This brings us full circle to the system of record problem for cost modeling. Although there is no ERP application that properly models the intricacies of complex, non-production service contracts or tracks ongoing spend and savings against them, we have observed some organizations pursuing this capability via other means.

Looking Ahead

Although indirect spend and savings visibility might seem to be primarily a procurement concern, it is actually a critical finance issue, especially since finance is often responsible for creating the performance measurement system by which all the functions and business units are measured. Further, finance must hold the entire organization accountable for cost and budget discipline and support the capabilities required to achieve bottom line results. Therefore, it is imperative that finance leaders help raise the awareness of the broader organization about the importance of being able to document savings realized. Processes and organizational mindsets must be retooled to support a culture of accountability and continuous improvement.

Most important, finance and procurement must collaborate successfully in the following three categories:

Savings accountability

- **Ensure that there is clear accountability and a process for validating savings and other value streams.** Also that procurement is not just doing deals and "pushing purchase orders," but rather, ensuring that budget owners can have confidence that results are being delivered and their needs are being met – regardless of who is executing the sourcing, purchasing and payables activities.
- **Clearly define all cost savings metrics and supporting assumptions.** Implement a balanced measurement system designed according to SMART principles[4] and tied into the company's broader enterprise performance management (EPM) capabilities.
- **Establish specific savings targets and cost baselines upon which savings will be measured and tracked.**

[4] SMART = Specific, Measurable, Actionable, Realistic, and Timely

Savings visibility

- **Create a closed-loop system that intelligently sets targets (e.g., by using benchmarks and internal stakeholder engagement techniques) and tracks savings as they are accrued**, even if there are different stakeholders and systems that need to be coordinated.

Savings repeatability

- **Establish systematic spend tracking that captures and categorizes data from all systems of record.** Analysis of integrated data enables strategic sourcing, improved compliance, consumption reduction, and spend planning. This last area is the ability to help budget owners budget more accurately by planning spending by looking at it both from the cost center and the supply market/supplier view. In this way, procurement can work with the budget owners to proactively shape and reduce consumption and costs.
- **Systematically monitor savings performance to identify opportunities for continuous improvement.**

Finance leaders who seek to improve their function's savings performance can achieve savings visibility using a variety of approaches: through the corporate center (e.g., within internal audit), an internal Center of Excellence, or a third-party procurement vendor (outsourcing and/or technology). If done internally, the capabilities outlined in this research require investment in the incremental FTEs and tools (data management, analytics, integration, etc.) needed to fix the problem. However, savings visibility is a multi-headed beast. The complexity of building a business case to change the fundamental measurement system itself, especially when compared to other capital-intensive projects clamoring for attention and funding. Also, because the nature of this spending is so distributed across the enterprise, a partial fix will only offer limited benefits.

Another approach adopted by some companies is the use of procurement outsourcing firms to professionally manage indirect spending, using the savings achieved to fund the building of internal capabilities. In this scenario, the outsourcer gets paid contingent upon its demonstration of realized savings. A few procurement BPOs are even commercializing their capabilities as hosted software and service solutions because of customer demand to make this part of an internal competency.

Regardless of your approach, the ability to measure and improve cost savings across a broad spectrum of spending categories is an important competency for finance. If finance is to take a leadership role in EPM, it must have a credible control system for not only steady-state performance measurements, but also performance improvements in all areas of spending. Addressing this challenge has a side benefit of identifying many areas in need of improvement and their underlying problems, such as fragmented spending data, poor master-data quality, weak process definitions, poorly defined roles, narrow performance incentives and fuzzy metric definitions. And these days, with cash on hand and profitability so essential, no stone should be left unturned.

About The Hackett Group

The Hackett Group, a global strategic advisory firm, is a leader in best practice implementation, advisory, benchmarking, and transformation consulting services, including shared services, offshoring and outsourcing advice. Utilizing best practices and implementation insights from more than 5,000 benchmarking engagements, executives use Hackett's empirically based approach to quickly define and prioritize initiatives to enable world-class performance. Through its REL brand, Hackett offers working capital solutions focused on delivering significant cash flow improvements. Through its Hackett Technology Solutions group, Hackett offers business application consulting services that helps maximize returns on IT investments. Hackett has worked with 2,700 major corporations and government agencies, including 97% of the Dow Jones Industrials, 73% of the Fortune 100, 73% of the DAX 30 and 45% of the FTSE 100.

Founded in 1991, The Hackett Group was acquired by Answerthink, which was renamed The Hackett Group in 2008. The Hackett Group has global offices in the United States, Europe, Australia and India and is publicly traded on the NASDAQ as HCKT.

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