

KPIs: Measuring Indirect Material Suppliers and Service Providers

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Abstract. Key Performance Indicators (KPIs) have traditionally been used to measure and manage direct material suppliers. Direct materials, by their very nature, lend themselves more easily to KPIs – direct materials are more tangible and can be measured fairly easily. Supply chain professionals managing indirect material suppliers and service providers are challenged with developing KPIs that specifically address the differences associated with these suppliers.

Fundamentally, the approach to measure and managing direct and indirect suppliers is the same; however, there are differences between direct and indirect suppliers. In order to effectively measure and manage indirect suppliers and service providers, a different set of KPIs, one that factors both the objective and subjective nature of indirect materials and services must be developed.

Case for Measuring Indirect Suppliers. Indirect spend, as used in the context of this discussion, is defined as any purchased good or service that does not end up in the product or service delivered to a customer. Direct spend is defined as a purchased good that is required to manufacture a finished good or a service that is provided to a customer.

Companies have traditionally measured direct suppliers' performance as a way to control quality, reduce costs and ensure timely performance. As companies continue to expand the depth and breadth of supply chain management, it is becoming increasingly important to measure and manage indirect material and service suppliers' performance. And for good reason – the average indirect spend for a Fortune 500-size company is approximately 50% of its total spend. Further, 5% annual growth is forecasted for indirect spend over the next 5 years. It is imperative that Key Performance Indicators (KPIs) are developed to measure and manage indirect suppliers' performance.

KPIs calculate a supplier's value to the organization by comparing the supplier's performance against the company's requirements to the total cost of the goods and services purchased from the supplier. The purpose of KPIs is to:

- Measure performance and improvement
- Manage supplier improvement efforts to your expectations and requirements
- Strengthen and improve supplier relations
- Develop suppliers

- Reward for performance
- Justify the supplier's inclusion in your supply base
- Identify the need to re-source a supplier

The end result is that KPIs drive continuous improvement.

Since Procurement has traditionally managed direct spend, KPIs have long been used to measure direct suppliers' performance. Developing evaluation criteria for direct suppliers draws largely on objective data that can be measured, usually in the three traditional areas of priority:

- **P**rice (total product cost)
- **D**elivery (performance to schedule)
- **Q**uality (process variability and consistency)

However, KPIs can also be used to measure indirect suppliers' performance too.

The Process for Measuring Indirect Suppliers. Measuring suppliers is a process of combining different measurements of "quality" into one single measurement of overall performance by assigning "weighted" values to each key element (or KPI) performed by the supplier and calculating a weighted score that can be used to track the supplier's performance.

Measuring indirect suppliers is more difficult due to a number of factors. "Maverick" spend is rampant and spend with indirect suppliers is often not captured in a company's data warehouse. Indirect goods and services are not subject to an incoming inspection, making quality measurement difficult, if not impossible. In some cases, delivery of indirect goods and services is not captured within a company's ERP system. Criteria and metrics typically applied to direct suppliers simply aren't always available for indirect suppliers.

Despite these challenges, it is possible to develop KPIs that measure indirect supplier performance. The first and most important step in beginning the process for measuring indirect suppliers is to obtain management support of the initiative. Once management support is in place, it is necessary to determine which suppliers will be measured and how frequently they will be measured. Criteria for supplier selection can be defined by a minimum amount of annual spend or critical supplier status. Determining how often to measure a supplier depends on your organization's industry and the type of supplier relationship. Measurement cycles range from 2 weeks to one year. Establishing the list of KPIs is the next step. This involves identifying the elements of an indirect good or service. Once the key elements are defined, the next step is to determine which elements are indicators of supplier performance and then to identify a methodology for measuring these elements.

For example, indirect suppliers can be measured on criteria such as contract compliance, customer satisfaction, cost competitiveness and continuous improvement. Attributes for each category can be defined in the following way:

Contract Compliance

- Actual cost versus budget
How did the supplier perform against budget – under or over the budgeted amount?
- Performance against Service Level Agreement (SLA) or Statement of Work (SOW)
How quickly does the supplier resolve issues relative to stated performance in an SLA or SOW?

- On-time deliveries (*if data is available)
How quickly does the supplier deliver relative to their SLA or SOW?
- Return rate
How many items are returned? How often?
- Order and Invoicing accuracy
Am I receiving the product I order? Am I invoiced for the price quoted?

*Customer Satisfaction**

- Customer Service
- Technical Support

*Usually obtained through customer surveys

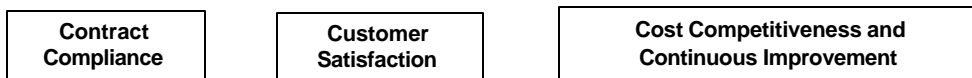
Cost Competitiveness

- Supplier pricing versus industry averages
- Supplier versus other benchmarks such as pricing quoted by another supplier

Continuous Improvements

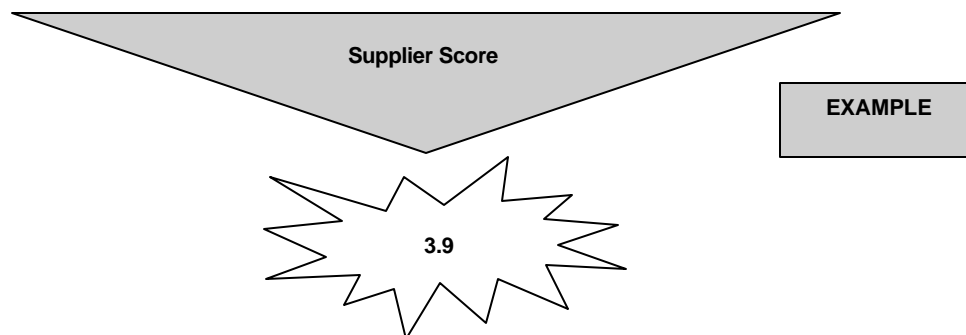
- Supplier Partnership Initiatives
- Cost Reduction Targets
- Cost reduction recommendations submitted by the supplier (measured by the type and number of suggestions received, ideas implemented and cost savings produced)

Indirect Supplier Evaluation



Weight X Score = Indirect Supplier Award Score

- Weight = 50%
• Score = 4
- Weight = 20%
• Score = 5
- Weight = 30%
• Score = 3

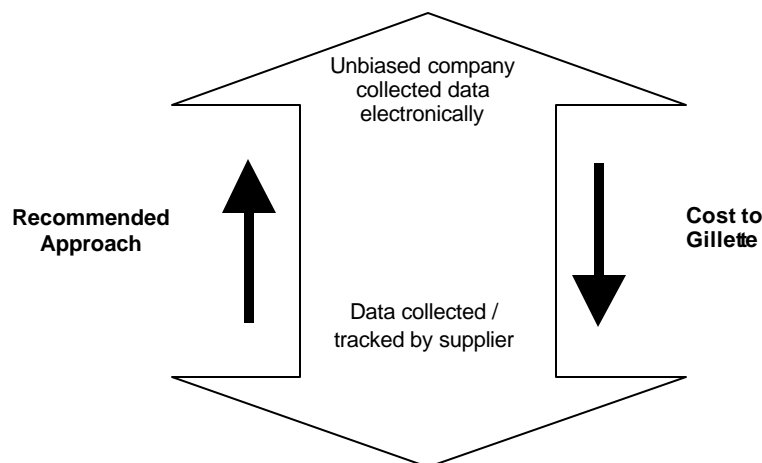


Be careful of what you measure. What you measure gets done and drives the supplier's focus. The metrics don't have to be complicated, but they must be tightly defined and communicated to the suppliers. Too many metrics result in a scorecard that is difficult to create and understand. Above all, the metrics selected must be controllable.

When developing the scorecard, flexibility is key. The scoring system must allow the ability to tailor scorecards to the good or service measured. Once the measurement categories are defined, the ability to select the attributes that represent the critical performance indicators is important. When determining what to measure, look for the most significant cost components and identify ways that the supplier's performance is driving those costs up or down. Supplier performance against each attribute is graded (for example a numerical grade of 1 to 5 with one 5 being the highest and representing performance that exceeds expectations). Weights can be assigned to each category so that the scoring system emphasizes those areas that are more important to the organizations. The weighting system must be also flexible so that adjustments can be made to reflect the importance of each category to the good or service measured. Engaging suppliers in the evaluation process leads to the selection of metrics that tend to be more objective and implementable because both parties participate in the process.

Once the scorecard is defined, data must be obtained. The methods for measuring and collecting data can range from standard forms for reporting or highlighting performance issues to using data sources that include the measuring organization's ERP system or data warehouse, supplier-provided reports, third-party data and benchmarks available in the public domain. It is important to attach reference materials to the scorecard for review with the suppliers. Having the data and documentation to support the scorecard is critical in order to establish the programs credibility with suppliers and provide the supplier with the necessary information in order to make improvements. Providing the data and documentation validates the scorecard and makes it possible for the supplier to take corrective action.

Data collection is the most difficult and time-consuming activity in the process. Teams must evaluate the costs/benefits of each data collection method available. Clearly, the goal is to drive towards data that is company-collected, non-biased and electronically provided. In some cases, it may be more cost effective and efficient to use supplier-provided data as you may lack the necessary resources and technology to collect the required data internally. Regardless of which method you choose, tracking and collecting data is integral to a successful KPI program.



The process doesn't stop with developing the scorecard. An effective supplier performance measurement program hinges on engaging the supplier. In the event that multiple business units share a single supplier, it is critical for those involved in managing the supplier relationship to align in order to ensure consistency. Optimal program results can be obtained

by socializing the measurement process with suppliers participating in the process and all internal stakeholders. When rolling out the program, advise the supplier that you are developing a supplier performance scorecard, educate the supplier about the program and convey that his/her involvement is required. The supplier can assist with scorecard review, ensuring agreement with measurement criteria and attributes.

Communication is critical. Scorecard results should be shared with the supplier on a pre-determined schedule. The frequency of sharing scorecard results varies from company to company as well as from supplier to supplier. When sharing the scorecard results, give the supplier an opportunity to dispute scores and to provide comments or feedback regarding the results. You may even want to consider implementing two-way feedback where the supplier not only responds to their scorecard, but also rates the customer. In the event a supplier relationship is terminated as a result of deficient performance, it's important to conduct an exit interview with the supplier to provide feedback.

Summary. KPIs have traditionally been used to as a way to control quality, reduce costs and ensure timely performance of direct suppliers. As companies strive to reduce costs further and expand the depth and breadth of supply chain management, it is becoming increasingly important to measure and manage indirect material and service suppliers' performance. Essentially, the same approach used to measure and manage direct suppliers can be applied to indirect suppliers by developing a system that reflects the differences between direct and indirect suppliers. In order to effectively measure and manage indirect suppliers and service providers, a different set of KPIs, one that factors both the objective and subjective nature of indirect materials and service and allows for flexibility in what is measured and how it is measured must, and can, be developed.

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