They're Never Satisfied – Taking Cost Reduction to the Next Level

Marilyn Gettinger, C.P.M., M.B.A.
President, New Directions Consulting Group
908-709-0656, mgettinger@aol.com

Abstract. Business forecasters predict that senior management will push supply professionals to cut costs approximately 3% per year for many years into the future. In some cases, the goal is as much as 12%. At the same time, CEO's also expect an increase in quality and an increase in delivery time. The purchasing department has been meeting the challenge. Buyers rate the pressure level at an 8 (out of 10) to uncover new cost reductions and that pressure has been on for the last 5-10 years.

In the past, buyers could leverage volume, use standardization efforts, shift inventory, provide forecasts, demand price cuts, and reduce inventory to accommodate senior management's demands for cost reductions. However, the pickings are beginning to look slim.

Each of the topics discussed in this presentation will focus on an area that offers new cost possibilities for supply managers who are pressed to continue their efforts to increase quality, delivery, and service but all at a lower cost.

The Purchasing Department itself offers an opportunity to increase the bottom line. The supply department must begin to consider itself a business within a business. An efficient procurement department thinks of itself as a profit center that makes money for its organization. In an efficient business, processes, systems, and supplies are managed without any waste and within a tight budget. Textbooks speak of the purchasing multiplier that states:

> \$1.00 saved in the procurement function in an organization with a 5% profit margin
> \$1.00/5% = Sales selling \$20.00 more of the company's product/service

This same formula may be applied to procurement efficiency.

> \$1.00 saved in the management of the procurement function/5% profit margin =
> A necessary increase of \$20.00 in the purchasing budget

Any monies spent on training and development can easily be covered by the value that is brought back into the organization. Buyers need to show what value they will bring back and implement in their organizations through attendance at Conferences, trade shows, seminars, etc.

> Ex: Savings/Investment = Return on Investment

Organizational Mission, Objectives, Goals, Challenges. A cost reduction program will ultimately fail if it does not consider aligning cost reductions with the mission, objectives, goals, and challenges of the organization itself. Cost initiatives must move the organization forward and must help the organization be successful in light of industry challenges. Yes, there would be savings, but those savings may not have the greatest impact.

The Language of Senior Management. Cost reduction efforts also may go unheard by senior management because they have not been translated from procurement speak to senior management speak. That language may be the bottom line impact, cost of goods impact, earnings per share, price/earnings ratio, customer service improvements, cycle time reduction, etc. Supply managers must identify the areas of importance of their decision makers and translate their savings into that language.

Transactional Costs. The continuous effort of identifying and eliminating transactional costs such as the administration of purchase orders, receiving, incoming inspection, invoicing is another hit at reducing internal costs. Organizations are beginning to ponder if there is really a need for a purchase order. With the skilled selection, development, and management of suppliers offered by supply professionals, long-term relationships can be based on detailed agreements and a lot of trust.

The more schooled that supply managers are in the e-commerce processes; the more successfully they can lead its implementation and the in-house training of the internal customer. One of the greatest contributions of e-commerce is the reduction in transactional costs. Supply professionals have been touting transactional reduction for some time now. Senior management has just awakened to this opportunity.

There are many other non-value added costs to uncover. One obvious one is when supply enters a project late into the process or is asked to solve a problem on an already in-process effort. The buyer or buyers must now go backwards and recreate all of the steps so that they can either handle the problem or take over the project. This would have been eliminated if supply had been part of the concept stage.

Price/Cost Margins. Big is not always big or efficient. Supply managers may find that suppliers, who are not listed as the top volume producers in an industry, may have a greater profit margin than far larger organizations due to in-house efficiencies. Those efficiencies may translate into savings possibilities.

Suppliers with high profit margins may be willing to provide funding on a project at a reduced interest rate or work out long-term repayment plans again at minimal interest rates. It is a lot easier for a supplier to stay in the door and grow with a buying company then to get its foot into another door and build a new relationship.

Relationships. CAPS published its five, ten, and fifteen year prediction of the role of procurement back in the late 90’s. That report stated that one of the top strategic roles for supply managers was that of managing supply relationships. There are enormous cost reduction opportunities to be gained in the various integrated supply relationships. CEO’s are excited about outsourcing, insourcing, vendor-managed inventory, in-house stores, vertical and horizontal integration, etc. These relationships offer the possibility of great cost reductions. However, without the skilled selection, implementation, and management provided by the supply function, none of these special relationships will meet their expected cost goals.

Consortiums and co-ops are other relationships that buyers must identify and propose to their organizations. Again, supply can help their organizations reap the total value of such alliances through skilled management and pre-planning to eliminate obstacles to the process.

Internal Alliances and Relationships. Another strategic area mentioned by CAPS is the building of relationships with internal customers. The earlier that supply can get involved in projects and gain information, the better the results will be. Supply can make better decisions on supply and materials due to the extra time with a reduction in costs, handling challenges, Increase in quality, reduction in delivery, and higher supplier performance.

Time Value of Money. Supply professionals must begin to consider that money grows and can also be used for the financing of other projects with a higher return on investment. Making sourcing decisions in light of this quality makes money for the organizations. Consignment, an integrated supply arrangement, wherein the supplier places inventory at the buying organization's location. The inventory is paid for as it is used not when it is received and invoiced. This relationship thus frees up cash that would otherwise go to pay the supplier's invoice. Along with freeing up cash, consignment offers a company a reduction in carrying costs. Even though there is still overhead and handling costs involved in consignment, the cost of money is reduced since the buying company has access to that money.

Lead Time Reduction. Lead time often generates the need for some safety stock to cover the length of time from an order being placed and the shipment being received. This adds on to the price of each unit of the product. With the reduction of lead-time, less buffer stock is needed thus reducing the adjusted price of the product.

Ex. Unit price x carrying cost per week x number of weeks of lead time + unit cost = adjusted cost

($15.00 x .0075 x 10 weeks) + $15.00 = ($.1125 x 10 weeks) =
$1.13 + $15.00 = $16.13
($15.00 x .0075 x 5 weeks) + $15.00 = ($.1125 x 5 weeks) =
$.56 + $15.00 = $15.56

Cycle Time Reduction.

Cycle Process Steps	Before	After
Raw material inventory	10 days	2 days
Work-in-process	10 days	5 days
Finished goods inventory	12 days	5 days
Invoice generation	5 days	5 days
Customer payment process	50 days	50 days
Total Cycle time	87 days	67 days

Supply managers by reducing raw material inventory through skilled order timing and supplier management and participating in reducing work-in-process efforts have reduced the cycle time of a customer order from 87 days to 67 days. Keeping in mind the time of value of money, this means the buying company has use of its money earlier.

Supplier Development. As stated by R. David Nelson, the process of proactively working with suppliers to improve all processes and apply lean principles offers a payback of 3-10 times the investment in time, money, and manpower. In fact, once effort and time is paid for, the rest is an immediate hit on the bottom line. Supply managers continue building their skills in this area.

Mergers and Acquisitions. Many organizations are looking for buying synergies through their mergers and acquisition efforts. Unfortunately, merging two or more companies with possible differences in product line, customer service concepts, values, mission, objectives, and goals is very difficult. More often than not, the volume savings and cross over benefits never materialize. This is an opportunity for supply professionals to take an active role in blending the various buys and implement their success.

Market Knowledge. The quicker that supply can gain market information and the quicker it can react on this information, the greater the cost reduction opportunities. If a supplier loses a large contract, the greater the opportunity for supply to negotiate a new price. However, supply personnel must always be scanning the horizon to spot such events. If the housing market drops, then builders will need less PVC piping. If the need for PVC piping goes down, then there is excess PVC resin. Excess PVC resin means a savings for supply. There are cost reduction opportunities when there are economic, technical, or other marketplace shifts. If a supplier has expanded his facilities and upgraded equipment, he may be able to offer you a more competitive price due to higher output and faster setup.

The Supply Chain. The financial view of the supply chain states that 70% of the organization’s assets are in its internal physical supply chain, 40-60% of every sales dollar is purchased materials, 7% of the revenue dollar covers MRO items, and 18% of the revenue dollar covers services. There is money in those chains. Supply professionals need to meet and work directly with not only their tier one supplier but also all of the other tier suppliers. Buyers are finding the lower tier suppliers have some great ideas on how to reduce costs. Also, the concurrent production throughout all of the tiers reduces the need for buffer inventory throughout the supply chain thus reducing inventory costs.

The Cost of Doing Business With Suppliers. There are suppliers that add very little value to the buying organization other than providing a product/service. Supply professionals need to consider what is the return on investment of a particular supply relationship. Does that supplier understand the challenges of the buying organization and the industry within which it functions? If not, then supply needs to communicate that information. Is that supplier willing to provide solutions in light of those challenges? Procurement will eventually be rated on how well its suppliers contribute value-added services to the organization and what new concepts the supplier has that can ultimately be made into products that the buying organization can sale.

Many purchasers are bringing suppliers together in supplier networks or focus groups to pinpoint potential savings. These focus groups are also meeting with the buying company’s customers to share trends and new ideas.

Cost reduction efforts will take a closer look at all costs and will span the entire supply chain. Cost drivers and cost reduction strategies will be established through increasing inter-firm cooperation. To be and stay competitive, all supply managers must join their senior management in never being satisfied.

REFERENCES

Journal or magazine article references:

Nelson, R. David, C.P.M., A.P.P., “Be the Ring Leader,” *Inside Supply Management,* October, 2002, p. 4.

“The Future of Purchasing and Supply: A Five- and Ten-Year Forecast,” *Study by ISM, CAPS, A.T. Kearny, Arizona State University, and Michigan State University*

Yuva, John, “Follow the Flow Reducing Cost Through the Supply Chain,” *Inside Supply Management,* June, 2000, pp. 48-62.

Yuva, John and Duffy, Roberta J., “The Revenue Stream Flows from Supply Management,” *Inside Supply Management,* October 2002, pp. 34-41.