Performance Management:
Linking Performance and Rewards to Supply Management Strategy

Tony Yakos, MBA, Senior Consultant
ADR North America, LLC
734/930-5070; tony.yakos@adrna.com

William L. Michels, MBA, C.P.M., CEO
ADR North America, LLC
734/930-5070; bill.michels@adrna.com

Abstract. In these uncertain times many companies are seeking to reduce purchase costs by having supply managers focus on driving down the costs of purchased goods and services. While many companies seek to attain cost reductions, they fall far short of their aspirations due to a lack of strategic supply management focus and employee performance metrics that are misaligned with the company's goals.

Introduction. One of the most important functions for today's supply manager is to drive out cost and bring value to the organization by strategically focusing on supply chain management. While this is the desired result of most organizations, the lack of supply management's goal alignment to the business strategy and the use of outdated employee performance metrics to drive the results often causes the buying team to under-maximize results.

Unfortunately, the employee compensation systems of the past have not kept pace with the rapid changes that have occurred in supply management. This has caused a problem in accurately evaluating current talent and hindered the attraction of new individuals that the industry is seeking for the role of the supply manager. The industry needs individuals who are business professionals with a strategic mindset and a capability to transfer the business strategy through the supply chain to the lowest level downstream.

To be effective, these leaders must be appropriately challenged with stretch targets and difficult, but attainable, goals. The performance measurement process to evaluate their progress must be rigorous, targeted and performance-driven. This discussion will focus on new performance/reward aspects of supply management.

Keys to achieving and measuring desired employee performance. Achieving the desired performance requires attention to several important areas:

- Assure rigorous, measurable goals which align with the business strategy
- Align purchasing goals with corporate goals
- Ensure that purchasing duties and responsibilities allow the group to focus on its goals
- Implement performance metrics that drive employees to achieve the corporate goals
- Ensure that performance metrics are measurable and observable
- Link rewards to performance metrics

Align purchasing goals with corporate goals. The goals of the organization should be used as a basis for the goals in the purchasing organization. For example, if the company wants to increase its profit margin by 15%, then purchasing's goals may focus on decreasing purchasing costs to drive down the cost of goods sold while maintaining current sales levels or increasing sales. Other organizations may want to offer new and innovative products each year, challenging purchasing with identifying new technologies or ideas from suppliers and bringing them to R&D for development. Other organizations may seek to get the product out the door to the customer and ensure on-time delivery. The purchasing organization in this instance will ensure that supplies are ordered and delivered on time to ensure that the product is shipped on time to the customer.

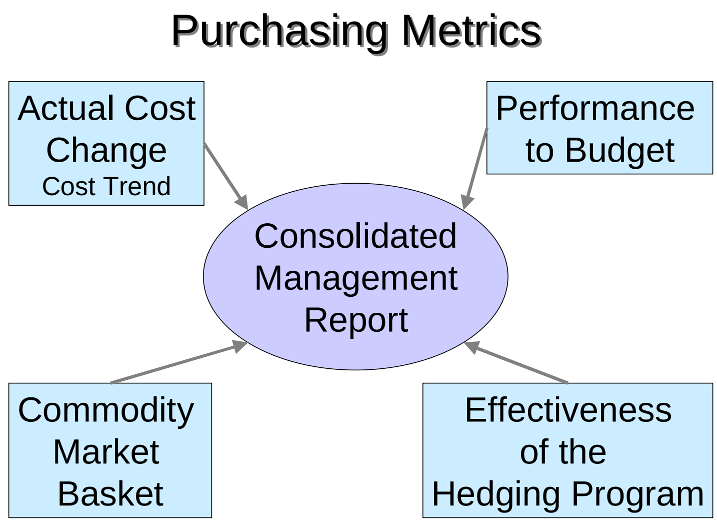
Ensure that purchasing duties and responsibilities will allow the group to focus on the goals. Many organizations may need to refocus the work of their employees to achieve the results wanted by the company. For example, an automotive supplier wanted to save approximately 5% on its purchased costs and deliver it as profit to the bottom line. The purchasing manager had to refocus his department onto negotiating contracts to achieve the 5% savings. The buyers' responsibilities changed from ensuring that the goods were received on time to focusing on cost and value. The responsibility for ensuring that the goods came in the door on time was given to the manufacturing function as some of the buyers assumed more of an order placing and expediting role. The purchasing manager separated his organization from the manufacturing organization, and he was then able to focus on cost and value.

Implement performance metrics that drive employees to achieve the purchasing and corporate goals. Ensuring that the actual employee performance metrics are aligned to the goals of the company and of the purchasing organization is of the utmost importance. If the individual performance metrics are not aligned to the departmental and corporate objectives, then the desired results will not be achieved. In the automotive case described above, the purchasing manager created new performance management plans and metrics that focused on achieving the 5% savings. The new plan focused on the necessary behaviors and actions necessary to achieve the desired results. The buyers had to segment their purchasing responsibility and ensure that they were getting the low-hanging fruit first and that the dollars of projected savings were worth the amount of effort and time a buyer would have to put into the project.

Ensure that metrics are measurable and observable. A purchasing manager must make sure that each employee's goals can be measured and must observe the behaviors of the buyer. The manager must also ensure that the measurement criteria effectively address the information the organization wants. For example, if a company wants to increase margin and a purchasing manager decides they will decrease costs 5%, then the measurement~~s~~ will have to look at the difference between current price and new price. Increases and decreases must be taken into account and the savings must be net savings. The manager must also be able to observe the behaviors of the purchasing staff. If the manager wants to see more strategic thinking involved in negotiations, then it may require the observation of the preparation that goes into a negotiation and a look at the documents created for the negotiation.

The following are examples of purchasing measurement tools:

Direct purchasing. In the case of raw materials, it is very easy to evaluate performance. The *purchasing metrics* chart below provides a typical example detailing how a typical company might evaluate performance.



Cost Trend (ZBM). The cost trend model looks at the actual change in price each month projected against the annual volume to produce a view for management of the actual cost impact to the business. It measures increases, decreases and net impact to provide management with a view of the actual cost trend. This analysis will provide a real view of how the dollars are changing.

Performance to Budget (PPV). This is the traditional purchase price variance model measuring actual to budget performance reporting the variances accurately.

Commodity Market Basket (CMB). This model describes how one might measure volatile commodities based on agreed market indexes to enable management to evaluate a company's performance to market and to enable management to separate purchasing performance from market forces.

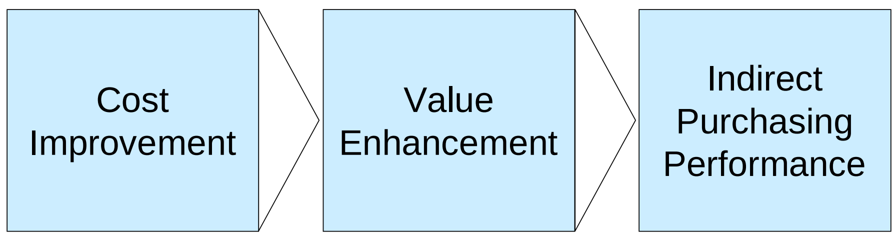
Hedging Effectiveness. This metric would evaluate a company's effectiveness in hedging for categories requiring futures and options purchasing. In addition to these metrics, an effective manager monitoring raw materials might develop goals and measurements for:

- Strategic purchasing
- Marketplace management
- Negotiation
- Supplier relationship management
- Cross-functional team effectiveness
- Personnel development
- Development of the purchasing process
- Procurement e-commerce progress

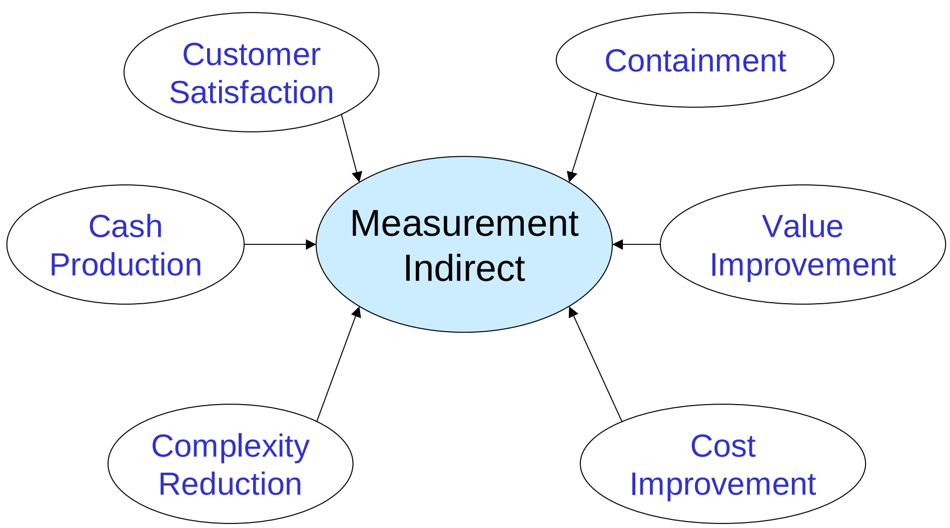
While the list of things to measure is not complete, the idea is that to improve individual performance, the metrics must be designed to achieve the goal, and that the measurement should be used to steer and drive progress on very difficult goals.

Indirect goods and services. This is where the expenditure is likely to be one time, and the opportunity for measurement is more difficult. The following charts identify some criteria for measuring indirect expenditure.

Primary Components for Indirect Measurement



Key Criteria for Measuring Indirect Purchasing



In the cases of indirect and direct expenditure, supply managers should be accountable and measured against supplier performance and quality metrics. In the case of supplier performance, continuous improvement in quality, delivery, cash, innovation and speed to market rest on the supply manager to achieve.

Link rewards to performance metrics. Rewards should be linked to the individual's performance metrics. If the metrics are aligned with company objectives, then the employee's performance rating should reflect the company performance. A manager should also ensure that rewards are linked to criteria that are easily measured and observed. For example, a manager can observe the process that the buyer is employing to achieve the desired savings. If the company wants to ensure that the product gets to the customer on time, then the individual should be rewarded based on the performance and management of the supplier.

Conclusion. Individual performance leads to company performance and company goals drive individual performance. It is the job of managers in all areas to properly align the goals and objectives of their departments to achieve the goals of the company. Managers must look at their organization and diagnose why they are missing corporate objectives or how they are going to achieve new corporate objectives. Managers will get what they inspect, not what they expect.