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The right way to procure indirect materials

A new IP standard offers a framework to get the most from your indirect spend.

& services

Strategic sourcing can be a source of competitive advantage for those firms that do it right. Yet, the majority of articles on procurement best practices have centered on direct spend, or the raw materials and goods that go into manufacturing a product. Very little attention has been paid over the years to the indirect materials and services that are used internally by a firm, such as MRO, fleet management and utilities, even though a large firm may spend a billion dollars or more on this category (see sidebar for a definition of indirect spend).

In many respects, indirect spend is the neglected pet of a procurement organization, no one individual or entity is paying attention to the category. Or, as a commodity manager for a U.S.-based medical equipment manufacturer once summed it up in an industry magazine: “There was no focus on indirect spend. As a result, organizations learned to fend for themselves in the indirect spend categories, and everybody was doing their own idea of what they thought sourcing was.”

We found similar attitudes toward indirect procurement (what we’ll refer to as IP) during discussions with a number of IP executives through the course of our research into the state of indirect procurement (see sidebar: About our research). Their experiences can be summed up in three points:

1. IP is often performed by a variety of different departments within an organization;
2. there are few well-defined processes and fewer outcome-based metrics for IP; and
3. there are currently no guidelines or standards for indirect procurement (this is true despite the fact that the medium to large companies

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we surveyed were buying from hundreds to tens of thousands of indirect suppliers).

To address these points, and to isolate best practices for indirect procurement, a team of academics and industry executives from Microsoft, Magna International and Intuit paired up with COPC, a leading standards and procurement company, to systematically investigate the process of strategic sourcing of indirect materials and services. The objective was to develop a “generic” IP standard. We did this through several steps detailed below. (In addition to the insights gained across the four strategic areas of the IP standard, the study provided the opportunity to collect demographic data from the responding companies and analyze potential correlations; see Top-level correlations sidebar.)

As indirect procurement encompasses the purchase of a large variety of commodities, the initial standard was geared to be generic enough to apply to all procurement types. The scope of procurement for the IP standard we were tasked with developing was supposed to encompass all procurement related aspects from the viewpoints of the internal customer—the business unit using the product or service—and the suppliers, including source-to-pay (excluding ordering and receiving of

goods/services); and the termination of a relationship with a supplier (or a contract). By definition, some of these processes were the responsibility of groups outside of procurement.

In this article, we used analyses of field data on the procurement of indirect materials and services in large organizations to come up with a framework of best practices or standards. Specifically, we examined the drivers and challenges and an enabling framework to guide strategic efforts toward indirect procurement success. The enabling framework comprises five key stages that are interrelated. We conclude with a set of key lessons learned based on companies that have deployed this five-category framework. (Due to space limitations, additional related charts are available online at scmr.com.)

Step 1: Engaging experts

The first step was to engage a focus group of top industry experts. We wanted to understand the current state with respect to sourcing of indirect materials and services. Those engagements led to a number of high-level conclusions that informed the standard.

1. Neglect of indirect spend compared to direct materials spend. In comparison to the attention paid to

About our research

A leading standards setting and consulting company (COPC Inc.) and academics from leading universities were tasked with developing a systematic process for indirect materials and services procurement. Five key areas of interest were selected to investigate:

- reporting/analytics;
- supplier relationship management (SRM);
- change management;
- risk management; and
- customer relationship management (CRM).

A maturity scale was developed for four of the above elements (excluding reporting/analytics) to assess how each indirect procurement (IP) organization rated themselves on these elements. A survey questionnaire was developed and piloted with three IP organizations. The questionnaire was uploaded to SurveyGizmo, the online tool used by COPC Inc. Thirty-eight IP organizations from leading companies were invited to complete the survey online. Twenty-two completed responses were received and formed the basis of the analysis in this report.

Some of the 22 respondents spanned multiple industries. The total number of industries represented in the sample was 32. 56.25% (18 of 32) of the sample was predominantly from three industries: manufacturing (25%);

automotive equipment & parts (18.75%); and electronics & technology (12.5%). The sample consisted of low-, medium- and high-spending IP organizations. The two largest categories in the sample (64%) were: respondents with an IP spend of over \$10 billion (23%) and respondents with an IP spend of under \$500 million (41%).

Thirty two percent of the firms reported that their IP organizations were centralized; 27% of the firms had decentralized IP organizations and 41% of respondent firms reported hybrid IP organizational structures. All respondents indicated they were responsible for sourcing suppliers and terminating suppliers. The majority of firms (over 80%) were responsible for developing a sourcing strategy and onboarding suppliers. Less than half of the respondents were responsible for ordering/inventory and paying suppliers. About two-fifths of respondents were responsible for ordering and inventory. About one-quarter of respondents were responsible for paying suppliers. To a large extent, it appears that IP organizations were not responsible for ordering/inventory or for paying suppliers. Almost all respondents reported that they conducted some forms of data analysis such as commodity spend analysis. However, very few respondents reported having conducted demand analysis for key commodities.

direct materials, little to no attention was paid to indirect materials and services in the sample of firms that were examined.

2. A “pocket change” mentality. Too often, procurement managers thought of indirect materials as “pocket change.” Devoid of data, the managers were operating under the false premise that the sums involved were too small to warrant their time. This was reinforced in the next point.

3. Lack of systematic data collection, organization, display and analysis capabilities. In part, the neglect of indirect procurement can be traced to gaps in the data collection, summary and display capabilities of procurement and ERP systems. Without a formal data strategy and approach, most analysis tends to be rudimentary and conducted on an ad-hoc basis. This is hard to justify, given that some of the category spend in indirect procurement can be in the millions to billions of dollars range—anything but pocket change, even to a large organization.

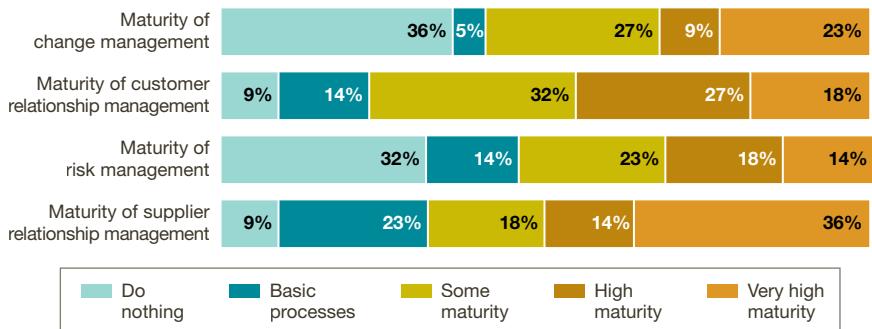
4. Not taking a process view. Most firms lack a systematic process for collating indirect spend because they feel no urgency to do so, especially when, in their view, there are bigger fires to fight.

5. Not involving people or the right people. Because many of the spend categories in indirect procurement transcend functional and departmental boundaries, the ideal setup would seem to be a cross-functional or dedicated-process team. While that approach is the rule for direct materials and capital expenditures, it is the exception for indirect materials and services.

6. Lack of metrics. Based on our focus group, there are no formal metrics for indirect spend. This is more involved than simply applying the metrics used in the direct spend category to IP. The real challenge is to develop a metric that is generic enough to cover the diversity within indirect procurement and yet be sensitive to a few localizing patterns that are peculiar to these category segments (especially, if they end up being a large proportion of overall spend of indirect materials and services).

FIGURE 2

Summary of benchmark study (high-level results)



Source: COPC Inc.

Step 2: Developing a standard framework

Using insights from the focus group, the second step was to develop a new industry standard for IP. A comprehensive standard framework would deliver benefits to the customers, or internal business units, as well as the suppliers of those goods and services.

Customers, for instance, should experience benefits such as clearly defined requirements that will effectively meet their needs; consistent, error-free and timely performance; well-designed processes followed by all well-trained

Defining indirect procurement

For this article, indirect procurement is defined as the sourcing of all goods and services for a business that enable various activities performed by the firm. In other words, goods and services classified under the umbrella of indirect procurement are commonly bought for consumption by internal stakeholders (business units or functions) rather than the external customers or clients. Indirect procurement categories include, but are not limited to:

- marketing related services (media buying, agencies);
- professional services (consultants, advisers);
- travel management;
- IT-related services (hardware, software);
- HR-related services (recruitment agencies, training);
- facilities management and office services (telecoms, furniture, cleaning, catering, printers);
- utilities (gas, electricity, water);
- consumable (grease, oil etc.);
- MRO (maintenance, repair, operations)
- capital goods (plant, machinery); and
- fleet management.

FIGURE 1

Indirect procurement standard framework



is shown in Figure 1, and was met with approval from industry participants. For instance, Mike Simms, Microsoft’s chief procurement officer, noted: “Sharing best practices while also establishing a framework to evaluate performance, measure improvement, and, ultimately increase business impact is a win-win for us and other companies who are participating in the development and governance of this new industry standard.”

Chris Flum, director of North American purchasing for Magna International, added: “The standard was an essential step in ensuring companies can implement appropriate best practices and benefit from the latest knowledge in this evolving area.”

The framework

As illustrated in Figure 1, five

category processes underlie the framework. They are:

Category 1: Leadership and planning. This is the starting point that comprises key activities such as: statement of direction; business planning; corporate responsibility and reviewing business performance. The purpose of this category is to give specificity to plans that pertain to the IP organization as closely as possible. To the extent this category can be considered a subset of an organization’s overall strategic planning process, it shows accountability and responsibility for all activities in this and the other four categories.

Category 2: Key business processes. After considering leadership and planning activities, Category 2 assesses the key business processes affecting IP. With the intent of expanding a wider net that includes the extended supply chain, this stage encompasses supplier facing, customer facing and internal facing processes, including: 1) customer relationship management; 2) defining sourcing requirements; 3) developing sourcing strategy; 4) developing/issuing RFXs; 5) selecting and contracting suppliers; 6) Implementing/onboarding suppliers; 7) paying suppliers;

relevant staff for consistent execution and performance; and clear documented agreements (with performance requirements) with all internal suppliers to ensure that end-to-end processes perform at target levels. Suppliers, meanwhile, should benefit from clearly defined requirements and metrics; a clear understanding of procurement processes, timelines and expectations; appreciation they will be treated fairly; and a mutually beneficial relationship.

To do so, we created a governance structure comprised of two committees: The first was a steering committee comprised of executives from leading organizations who are responsible for all (or most) of their company’s indirect spend. Initial participation in the steering committee was limited to North American individuals, with future plans to add global representation on the steering committee.

The second committee was a technical advisory council comprised of key individuals who manage or are subject matter experts for a significant portion of their company’s indirect procurement operations.

The IP standard framework that came out of this process

Source: COPC Inc.

8) supplier relationship management and 9) terminating supplier relationships.

The internal processes adopted for IP are consistent with strategic sourcing processes for direct materials. Similarly, supplier relationship management and customer relationship management were directly related and traced to IP.

Category 3: Key support processes. Category 3 considers the six key support processes for an IP strategy: 1) change management; 2) risk management; 3) corrective action and continuous improvement; 4) compliance 5) key support supplier management; and 6) data analytics and market intelligence.

These key support processes cover a firm's posture on risk assessment and mitigation and compliance processes that ensue from them. Business continuity planning completes the risk cycle. Overall change management that reflects a flexible culture was another key facet of support processes. Supporting internal supplier relationships with organizations within the company but outside the IP organization that support the IP organization is an important component of this category, as are data analytics and market intelligence to support all aspects of IP.

Category 4: Key people support processes. Category 4 focuses on the key people needed for an IP strategy, based on three activities: 1) recruiting and hiring; 2) training and development; and 3) managing staff feedback. Given the importance of human capital, this category involves hiring the right people and actively looking for new talent. Investing in training and developing employees is important after hiring. The last part is constant interaction with employees that includes actively seeking their feedback to promote a sense of belonging.

Category 5: Performance measures. The key performance measures considered in Category 5 are: 1) customer satisfaction; 2) supplier satisfaction; and 3) business

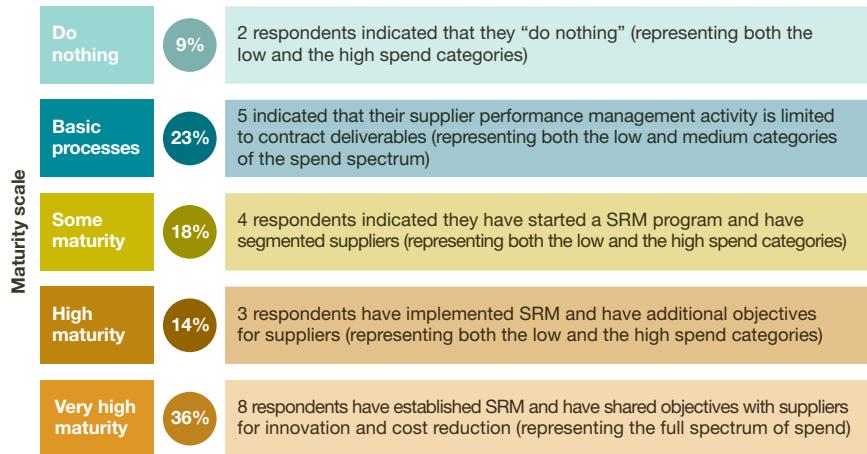
TABLE 1

Benchmarking analyses for SRM

GOAL: Determine how indirect procurement (IP) organizations handle SRM within their organizations

KEY LEARNING:

- Of the four areas benchmarked, SRM has the most maturity across respondents
- 68% of respondents have indicated some level of maturity in this area having started SRM
- 36% responded with the highest level of maturity



- 1 of 9 respondents (11%) with under \$500 million in spend was at the top box level for SRM
- All 6 of the respondents with over \$5B+ in spend were at the top box level of maturity for SRM

KEY LEARNING: Strong correlation between spend and maturity for SRM

Source: COPC Inc.

performance. The associated metrics track outcomes of customer facing and supplier facing processes, and internal bottom line outcomes.

How mature is your IP?

Following the development of the IP framework, we selected five key areas of interest for detailed investigation. They included:

- reporting/analytics;
- supplier relationship management (SRM);
- change management;
- risk management; and
- customer relationship management (CRM).

A maturity scale was developed for four of the above elements (excluding reporting/analytics) to assess how each IP organization rated themselves on these elements. The results for benchmarking the IP respondents are presented in the accompanying tables.

Rating of supplier relationship management (SRM)

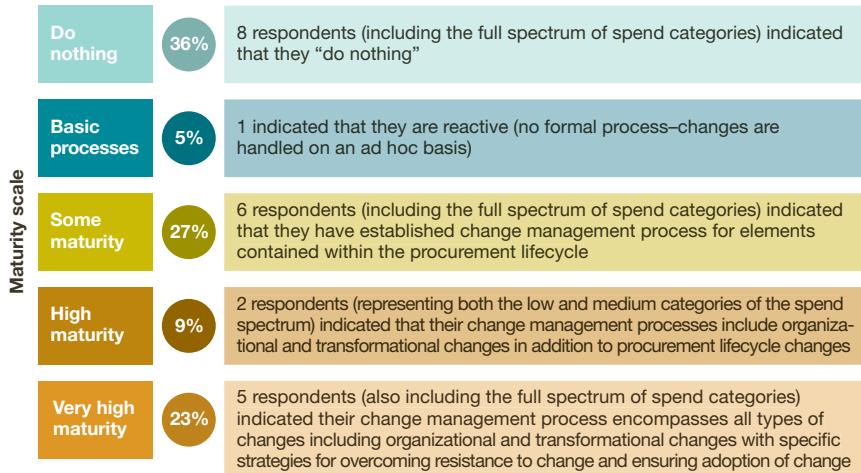
Of the four benchmarked areas, SRM (Table 1) had the most maturity across respondents. For example, 68% indicated

TABLE 2

Benchmarking analyses for change management

GOAL: Determine how indirect procurement (IP) organizations handle change management within their organizations

KEY LEARNING: No direct correlation between spend and maturity of change management process in IP



KEY LEARNING: Over half have some level of defined change management process, just under half of the respondents do not, and may benefit from reviewing best practices in this particular area, regardless of where they fall on the spectrum

Source: COPC Inc.

some level of maturity in this area by having started an SRM program, and 36% responded with the highest level of maturity. Only 9% of respondents said they were doing nothing in this area. More importantly, there was a strong correlation between spend and maturity for SRM. Only one of nine respondents with under \$500 million in spend was at the highest level of maturity, while all six of the respondents with over \$5 billion in spend were at the highest level of maturity for SRM.

The overall objective of the SRM program in leading IP organizations was to have a smaller but more strategic supply base to drive both price competitiveness and partnerships with vendors. To measure the impact of SRM, the following metrics were used: savings and implemented continuous improvement (CI) opportunities; business and supplier satisfaction; three to five innovative ideas annually; maintaining a healthy index of 95% compliance to contract; cost optimization and the number of innovation collaboration initiatives (ICIs).

The governance model for managing strategic suppliers included: establishing annual category plans with SRM targets; conducting monthly operations reviews to assess progress; ensuring representation across enterprises by meeting

quarterly to govern all different aspects of SRM performance; and looking for opportunities for centralization to drive strategy, technology and innovation. Centralization also helped detect market trends early, improved communication and ensured standardized disciplinary actions. Furthermore, these IP firms conducted annual executive business reviews and distributed supplier surveys to assess value, performance, innovation and customer service.

One key lesson from the SRM process was that the use of world class SRM processes, tools, templates and training—guided by technology—facilitates standardization, effectiveness and efficiency as well as collaboration.

Rating of change management

The key lesson from the change management module (Table 2) was that there was no direct correlation between spend and the maturity of the change management process. Over half of the surveyed respondents had some level of defined change management process in place. The other half, with no formal change management process in place, could benefit from reviewing best practices in this particular area, regardless of where they fell on the spend spectrum.

The best practices reported with respect to change management were: handling of changes via amendments to purchase orders (POs) or contracts; using system tools to log, track and manage change requests; having a series of reviews, approvals and signoffs that are managed by category managers; establishing standard procurement signing authorization levels, and in many cases, the IP organization conducting the negotiation. In terms of monitoring change, the best practices included: manual monitoring on an ad hoc basis; team-level self-monitoring; tracking variance to budget; establishing metrics prior to implementation, reporting results against metrics post-implementation via operational reviews; ensuring executive sponsorship; and ownership of results and leverage project management planning (PMP) structure for

major projects.

Finally, the tactics used by leading IP organizations to handle resistance to change included: reacting to resistance on an ad hoc basis where necessary; establishing clear stakeholder/business owner alignment and sponsorship of change prior to implementation; using communication language choices to describe changes in an inspiring manner (i.e. cost savings vs. money left on table); providing transparency to decision-making rationale; conducting pre-analysis/assessment of resistance factors for executive management; engaging with customers prior to change to gain perspective and buy-in; and establishing training and education plans to ensure understanding of benefits of the change (i.e. readiness planning).

Rating of risk management

Risk management (Table 3) had the lowest maturity of the four elements (46% in the bottom two boxes). The data also suggest that while over two-thirds have some level of defined risk management process in place, just under a third of the respondents do not have a formal risk management process in place. These firms may benefit from reviewing best practices in this particular area. The level of maturity of risk management was higher in lower spend companies, based on self-assessment.

The key themes and best practices highlighted from the IP organizations on risk management were requiring business continuity plans (BCP) or disaster recovery plans (DRP) within their contracts. Another exemplar risk management practice was splitting contracts at the sacrifice of price to mitigate risk, and to engage with alternate suppliers. Cutting-edge firms created mitigation plans based on risk types such as: meeting regulatory/legal requirements; threats to market share or brand reputation; criticality based on potential impact on business; and events that could cause project or business delays. Also, leading firms

TABLE 3

Benchmarking analyses for risk management

GOAL: Determine how indirect procurement (IP) organizations handle risk management within their organizations

KEY LEARNING: The level of complexity/maturity of risk management structure was higher in lower spend companies, based on self-assessment, risk management had the lowest maturity of the four elements (40% in bottom 2 boxes)



KEY LEARNING: These statistics highlight that while over two-thirds have some level of defined risk management process, just under a third of the respondents do not, and may benefit from reviewing best practices in this particular area

Source: COPC Inc.

defined risk factors formally such as reputational/brand risks; labor law breaches; resource limitations; information security and privacy; fraud and data security; supplier capacity imbalances; cost pressures from business groups; geopolitical and market risks; financial and currency exchange rate risks, and physical safety risks.

For all of these factors, leading IP firms analyzed all high risks after categorizing all risks as low or high risk. These companies also evaluated critical suppliers for financial and physical disruptions and established standardized supplier risk ratings. Special priority was given to risks relating to fraud, cyber security and financial risks. Finally, many IP firms included supplier risk questionnaires as part of the RFP processes.

Rating of customer relationship management (CRM)

As seen in Table 4, a majority of respondents proactively engage with their customers through customer relationship management (CRM). It appears that IP Organizations that have over \$5 billion in spend are most likely to employ CRM. The data also suggests that IP organizations with

higher spend and more IP staff tend to more proactively engage with customers.

In terms of key takeaways and best practices, the data revealed that measuring customer satisfaction provided useful insights to the IP organization to assist in further engaging with customers. Respondents with higher levels of maturity were also surveying their customers. However, most IP organizations in our survey sample were not capitalizing on this source of information to drive actions that improve customer satisfaction.

Lessons learned

In this article, we have highlighted an industry-wide gap in a consistent way to approach indirect procurement. This, despite the growing evidence of the strategic importance of IP to overall spend and the “mistakes” made by organizations brushing off the importance of IP despite evidence pointing to the contrary. A new IP standard framework is a major step forward in closing this gap. And, based on the analysis of our research, there are a number of important lessons learned for each of the four stages covered by the standard.

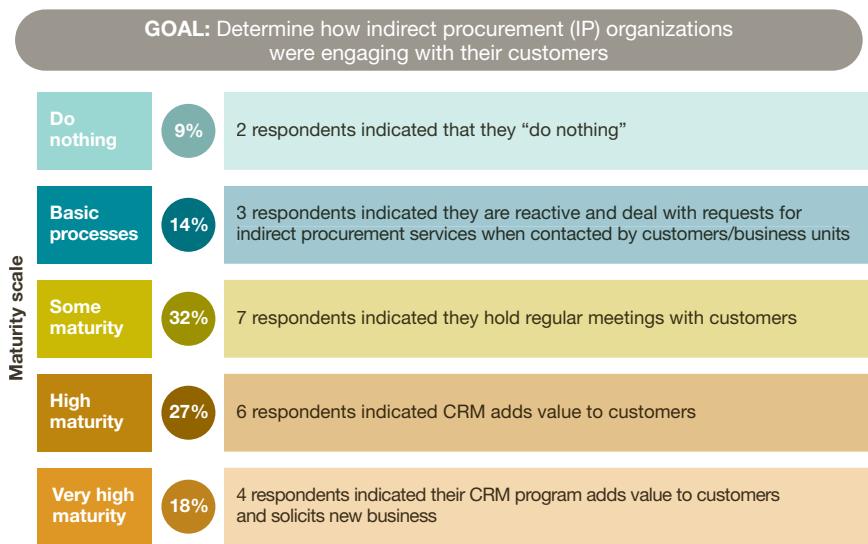
Supplier relationship management (SRM). As noted earlier, SRM was reported to have the highest level of maturity among the respondent IP organizations. The most frequent segmentation criteria (or basis) for inclusion of suppliers was spend amounts and criticality of commodity being procured. In contrast to CRM, measuring supplier satisfaction as part of SRM was deemed to be important by only 32% of the respondent IP organizations. While, the theory on supplier development and supplier enrichment calls for a joint consideration of the focal firm’s objectives with the standard and the suppliers compliance to the standard, our data appears to support the idea that firms are a long way from this ideal. For the majority of IP organizations, the focal firm tended to dictate terms and policies when it came to SRM, and preferred the status quo.

Change management (CM). In our sample, over half of the respondents had reported some level of defined change management process in place. At the same time, just under half of the reporting IP organizations did not have change management processes in place, regardless of where they were on the spend spectrum.

Risk management (RM). In our sample, over two-thirds of the reporting IP organizations had some form of risk management process in place. Moreover, the level of complexity and maturity of risk management was higher in lower spend companies. This is somewhat perplexing as one would expect that maturity of risk management should have been higher in high spend companies due to higher exposure. It seems that high spend companies need to invest more in improving their risk management processes. It may also be noted that risk management was overall the lowest maturity area across organizations, with 55% of respondents indicating some level of maturity.

TABLE 4

Benchmarking analyses for CRM



- KEY LEARNING:**
- The majority of respondents proactively engage with their customers
 - The IP organizations that have over \$5 billion in spend are most likely to engage their customers
 - Data suggests that IP organizations with higher spend and more IP staff tend to more proactively engage with customers

Source: COPC Inc.

Customer relationship management (CRM).

Findings from our field research revealed that most respondents proactively engage with internal customers. This is natural as many functional entities via the request for quotes (RFQ)/request for proposals (RFP) processes would have to deal with the IP organization. However, our results also revealed that the objectives of IP were not aligned with the objectives of internal customers. This calls for more communication and real time monitoring to assess the extent of misalignment and then formulate strategies to fix the gaps. With respect to external customers, our research revealed that approximately 60% of the sample IP organizations stated that customer satisfaction was an important metric to gauge the effectiveness of the CRM process. However, only 40% of the sample IP organizations actually measured customer satisfaction. There appears to be a lag in maturity levels with respect to CRM among IP organizations.

With the development of the “Indirect Procurement Standard Framework,” and the lessons learned, we believe there is a tremendous opportunity to transform indirect procurement from the neglected pet of a sourcing organization into a vital component of strategic sourcing. Competitive advantage and savings are available to those organizations that employ the standard and do indirect procurement the right way. ☺☺

Acknowledgements

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Top-level correlations

In addition to the key insights gained across the four strategic areas of the IP standard, the study provided the opportunity to collect demographic data from the responding companies including: amount of IP spend, industry representation, size of IP organization, level of centralization of the procurement function, and whether or not a corporate mandate exists for the IP organization to be used for all procurement related activities. As a result, several potential correlations could be analyzed and assessed based on the responses provided. The questions addressed are listed below.

- Are some industries doing more in certain elements of procurement than others?
- Are more centralized organizations further up the maturity continuum?
 - Is spend a predictor of maturity?
 - Does the size of the organization relate to the level of maturity?
 - Does having a corporate policy mandating usage of the IP organization for procurement relate to the operation being centralized?
 - Does having a corporate policy mandating usage of the IP organization for procurement relate to the percentage of spend under management by the organization?

There were a number of key lessons from the questions referenced above. For example, respondents indicated a great deal of diversity in maturity among IP

organizations. Also, there was disconnect between the objectives of the IP organization and internal customer objectives. This disconnect can be alleviated with the inclusion of customer satisfaction as a specific metric in the IP framework.

We also found that most IP organizations are not responsible for ordering, inventory management or for paying their suppliers. This could lead to coordination problems as one part of the organization does not know what is happening in the other parts with respect to the same spend item or supplier. While paying suppliers could be viewed as a centralized function, not taking into account ordering levels, including reorder points for key commodities, can be highly risky. Similarly, not tracking the inventory of A and B items could be disastrous, especially if there is a significant spend across these categories.

Another key finding was that there is correlation between spend and maturity levels. In other words, IP organizations with high spend levels also have the highest levels of maturity (awareness and implementation) with respect to structured IP processes.

Finally, while almost all respondents reported having conducted some form of data analyses, very few analyzed the demand for specific products or services. Taken with a previous point about not tracking inventory levels, this implies a tendency to do maverick buying as opposed to reacting to true demand points and patterns.

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