

Principles of Purchasing

Lecture 7

Strategy in purchasing

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Lecture Learning outcomes

At the end of the lecture, you will be able to:

1. Understand the strategic sourcing process
2. Evaluate the market dynamics and supplier relationship
3. Apply performance measurement in purchasing

Introduction

Strategic Purchasing/sourcing is a concept that was popularized by major consultancy companies in the late 1980's 1990's and is now considered a standard purchasing strategy used by many blue-chip companies.

Strategic sourcing is the process of taking advantage of purchasing opportunities by continually reviewing current needs against purchasing opportunities. Strategic sourcing was first established by General Motors in the 1980's and is now a common business purchasing tool. The rise of China and its manufacturing capabilities has opened up numerous strategic purchasing opportunities.

There are several processes within the strategic sourcing/purchasing process and these are:

- Evaluation of the company's current purchasing cycles.
- Evaluation of what is currently available in the supply market.
- A review of the cost benefits analysis of using other suppliers.
- A review of potential vendors.
- An update of the current procurement strategy
- Negotiations with potential vendors to ensure that they meet the new procurement strategy and cost benefit analysis.
- Implementation of the new vendor relationship.
- On a continuous process, review and update the strategic sourcing.

ROLE OF STRATEGIC SOURCING

Strategic sourcing is one of the key methods that purchasing departments are using to lower costs and improve quality.

Strategic sourcing involves analyzing what products the company buys in the highest volume, reviewing the marketplace for those products, understanding the economics and usage of the supplier of those products, developing a procurement strategy, and establishing working relationships with the suppliers that are much more integrated than such relationships were in the past.

During this process, the team conducting the analysis should ask these questions:

- Why do we buy this product or service?
- What do we use it for?
- What market conditions do suppliers operate under?
- What profit margin do suppliers seek to obtain?
- What is the total price of purchasing from a particular vendor (in other words, the cost of the item plus the costs associated with quality problems)?
- Where is the good or service produced?
- What does the production process look like?

The products that are purchased in the highest volume will be the best candidates for cost reductions. That is because once those products are identified, the company can then justify the time and expense needed to closely study the industry that supplies that product.

It can look at the ways key suppliers operate, study their business practices to see where the most money is added to the final cost of the product, and then work with the supplier to redesign processes and lower production costs. This maximizes the contribution that suppliers make to the process.

If the supplier is willing to partner, then analysts have identified several traits that good suppliers share:

- commitment to continuous improvement
- Cost-competitive
- Cost-conscious
- Customer-oriented
- Encourages employee involvement
- Flexible
- Financially stable
- Able to provide technical assistance

-Analysts indicate that suppliers receive some benefits in the emerging purchasing dynamic as well.

-Reduced paperwork, lower overhead, faster payment, long-term agreements that lead to more accurate business forecasts, access to new designs, and input into future materials and product needs have all been cited as gains.

Establishing a Good Strategic Sourcing Methodology

Generally, strategic sourcing is implemented with the goal of applying purchasing savings to some other aspect of the business.

The first step to a good strategic sourcing methodology is, unsurprisingly, to define the goals for the company. Beginning with the end system in mind is critical to developing a working program. Identifying scope, objectives of the program and internal requirements are just the beginning.

The second step is track and analyze internal spending. This can be done by aggregating data from current procurement and accounting systems or by the implementation of e procurement throughout the company.

The third step involves the leadership team developing commodity strategies using:

- Best Price Evaluation,
- Volume Concentration,
- Product Specification Improvement,
- Joint Process Improvement,
- Relationship Restructuring and
- Global Sourcing.

Many times, this is the point where an e procurement system or other robust acquisition tool becomes part of the overall product sourcing methods.

The fourth step; once the strategy is in place, the actual mechanics of strategic sourcing can begin.

The fifth step; Finally, awarding the contract is just the beginning. The buying company continues to communicate expectations, performance, supplier performance, and establishes both awards and penalties for various levels of service. Once the contracts are in place, a good strategic sourcing methodology demands that analysis continue on each contract.

Ten Golden Rules of Strategic Sourcing

1. Avoid a piecemeal approach: Leverage sourcing as an integral component of your overall business strategy.
2. Be strategic: Ensure that your service delivery model is not only aligned with, but will also drive forward, the enterprise's ambitions.
3. Take a holistic, enterprise-wide approach: This will maximise economies of scale, avoid duplication and ensure continuity of standards.
4. Sourcing is not synonymous with outsourcing: Review your present operating model and create a roadmap for future requirements that considers all of your options both internal and external, while balancing value, risk and speed.
5. Sourcing is an ongoing process, not an isolated decision: By deploying flexible services from wherever they are best provided, you can quickly and effectively respond to changing market conditions.
6. View service providers as partners: By keeping service providers informed of business goals and constraints as they evolve, and by structuring the relationship so that it is beneficial to both sides, your partners can innovate and transform in order to provide long-term value.
7. Ensure buy-in: Executive sponsorship, centralised management and company-wide support a vital for success.
8. Identify the changes necessary to move to the new model: Communicate a compelling vision of the future that conveys the competitive advantage for the company and the opportunities for employees.
9. Service Management & Governance: Develop a corporate Service Management & Governance function with the skills and systems needed to drive effective sourcing strategy, execution and management.
10. Seek independent advice: Develop an informed perspective on your current operating costs and performance vis-à-vis the market and the future potential of your target operating model.

Some Purchasing strategies

1. Bulk Purchasing

This is Buying in large quantities to benefit from economies of scale, often resulting in volume discounts and this led to lower unit prices. This method has the following benefits.

- Reduced Ordering Frequency leading to fewer orders hence lower administrative costs.

- Improved Supplier Relationships due to large consistent orders which foster better supplier terms.

2. Vendor Managed Inventory (VMI)

The supplier manages the inventory levels for the organization, replenishing stock as needed, which reduces the buyer's need to monitor stock levels closely.

3. Outsourcing

Contracting external suppliers for services or goods instead of producing them in-house, allowing the organization to focus on core activities.

4. Strategic Partnerships

Forming long-term relationships with key suppliers to secure a consistent supply, often with negotiated pricing and quality assurances.

5. Global Sourcing

Procuring materials or products from international suppliers to reduce costs or improve quality.

6. Green Purchasing

Prioritizing environmentally friendly or sustainable products, often to support the organization's corporate social responsibility (CSR) goals.

7. Consignment Purchasing

Having goods delivered and stored on the company's site, with payment made only once items are used or sold, helping to reduce inventory costs.

8. Competitive Bidding

Using requests for proposals (RFPs) or requests for quotations (RFQs) to solicit bids from multiple suppliers, encouraging competition to achieve better terms.

9. E-procurement

Using digital platforms to automate and streamline purchasing processes, which can reduce procurement cycle times and improve supplier selection.

10. Supplier Consolidation

Reducing the number of suppliers to a select few strategic partners, improving volume discounts and simplifying management.

11. Just-In-Time Purchasing

- Just-in-time (JIT) manufacturing is one of the biggest trends in all facets of industry in the 1990s.

- JIT companies maintain only enough inventory to manufacture the products they need in the very near future. Parts are ordered on a near-continuous basis and often go directly from the loading dock to the assembly line.
- The benefits of this system include reduced inventory, improved quality, reduced lead time, reduced scrap and rework, and reduced equipment downtime. However, when a company shifts to JIT manufacturing, it must also shift to JIT purchasing.
- Traditional purchasing meant building a supplier list over time by constantly adding new suppliers, spreading purchases around, and maintaining higher inventory levels in case demand for a product soared or quality from a supplier dipped suddenly.
- JIT purchasing demands that buyers narrow their supplier list to a chosen few who can deliver high-quality products on-demand and in a timely fashion.

Purchasers must look for a minimum of three things in suppliers:

- 1) Demonstrated excellent quality.
- 2) Ability to make frequent, on-time deliveries; and
- 3) Ability to provide very large volume commitments or single sourcing arrangements.

PURCHASING PERFORMANCE MEASUREMENT SYSTEMS

The fundamental objective of a purchasing and supply chain performance measurement system is to aid in strategy implementation through formal systematic approach to monitoring and evaluating purchasing activities.

History of performance measurement systems

- Performance measurement system have evolved over time, from quality being the largest concern in the Japanese industries during the 70s, while western companies were more concerned over service and return on investment.
- During the 80s a new era for measurements had its beginning and companies started to focus more on quality, time, cost and flexibility.
- The focus then shifted during the 90's when scholars started to criticize traditional financial measurements and started to focus more on effectiveness and efficiency of actions.

- From there on several different non-financial factors such as quality, customer satisfaction, cycle time and innovations became leading indicators to measure financial performance.
- And in recent years, environmental impact and social sustainability have gained importance, this has led to the evolvement of performance measurement systems. Because of this, several different models have developed.

Performance measure as signaling device

- Management can use performance measures as a means of signalling and influencing the actions of the people who are responsible for performing tasks.
- Performance measures may send conflicting signals to buyers, with both measures often disconnected from both corporate and supply strategy.
- Performance measures must be carefully designed to suit the needs of the organization in order to avoid resources being allocated in sub-optimal way.
- A well system should support and encourage performance in the areas which are critical to firms' success.

Cascading performance measure

- Effective performance measurement system should cascade the high level corporate strategy down into the lowest levels of the organizations signalling expectations and desired behaviours to employees.
- The aim is to create an alignment between the corporate strategy, supply strategy, goals and objectives, performance measures and ultimately the actions of the individual responsible for carrying the work.
- For purchasing to contribute to the success of the organization, it is vital that it derives its strategy from corporate.
- Purchasing therefore requires a clear alignment with the broader corporate thrust

Benefits of measurements

Performance measure can help focus purchasing on adding value in a number of ways;

- Decision making. Right measures enable improved decision making, by directing activity which is aligned to the needs of the organization and identifies variances from planned results.
- Communication. Establishing targets which are relevant to both purchasing personnel and their internal customers can facilitate an improved level of communication

throughout the organization. It is important that other functions are aware of the contribution which purchasing can make so they may draw on it to their own advantage.

- **Visibility.** A well-structured set of objectives and targets will improve the visibility of activity both within the purchasing process and with the departments, identify areas of waste in terms of defects, delays and surplus and mistakes. It may also contribute to the status and profile of purchasing with the organization

Problems with measurement

Measurement particularly where the determinants of performance across organizational boundaries is extremely difficult process. Numerous problems may emerge, which limit the effectiveness of the purchasing performance measurement system. These are:

1. **Conflicting messages.** Problems arise when conflicting messages are received by managers and buyers regarding what is expected of them, or when measures are derived which are not directly related to the organizations purpose.
2. **Collection of inappropriate information.** Problem may arise because the measurement system in use was not originally designed as a measurement tool, but rather to meet operational requirements.
3. **Lack of congruency.** Fundamentally there is no point in measuring an activity unless the results inform the recipient of how well various goals are being met.

Key performance measurement concept

1. **Efficiency.** Is the relationship between planned and actual sacrifices which are made to be achieved agreed goals (it is, in effect an operating ratio of effect against results. These may depend on organizational factors such as the work done, certain procedure.
2. **Effectiveness.** Effectiveness is the extent to which a goal can be met using a chosen course of action. Supplier development, value analysis, forward buying programmes and lead time reduction all impact on assessment of purchasing effectiveness.
3. **Cost based measures.** Price performance indicators may be misleading in many ways. Assessing buyers against the price may be blurred by quality, discounts, payments terms, credit and currency fluctuations.
4. **Financial and non-financial measurements.** Performance measurement systems in many of today's companies focus on historical rather than the future performance, financial rather than operational indicating internal rather than external data, and numeric rather than qualitative results.

5. Identify stakeholders. Any assessment of performance should be brought about with the active involvement of all those who are affected by the activity. Whether good or bad purchasing is largely determined by the perception of internal customers to provide a service.
6. Gaining buy-in. Performance measurement is that measures designed at each organizational level should include specific input of the teams which will be responsible for delivery the process against those goals.

Conclusion

In conclusion, strategic sourcing is a vital approach in modern procurement, focusing on optimizing cost and quality through well-planned supplier relationships. It offers a structured methodology that integrates purchasing with business goals, allowing companies to leverage supplier capabilities effectively. By employing diverse sourcing strategies, organizations can reduce risks, ensure supply chain continuity, and enhance operational efficiency. This cohesive approach to sourcing empowers companies to adapt swiftly to market changes, maintain competitive advantage, and sustain long-term growth.

Revision questions

1. What is strategic sourcing, and how did it become a widely adopted concept in business procurement?
2. Identify and describe the key steps involved in the strategic sourcing process.
3. What role do supplier characteristics play in successful strategic sourcing, and which traits are most valued in supplier partnerships?
4. Outline the ten golden rules of strategic sourcing and discuss their impact on effective purchasing strategies.
5. What are some challenges associated with purchasing performance measurement systems, and how do these systems add value to an organization?