Stop Misallocating Purchasing Resources
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90th Annual International Supply Management Conference, May 2005

Abstract. Procurement organizations need to carefully consider the allocation of staff between direct and indirect (including services and MRO) procurement departments. The rapid and continuing growth of outsourcing is shifting the proportion of procurement spend away from direct procurement of parts for manufacturing toward the procurement of services, especially complex services like manufacturing or logistics. Yet, procuring complex services is quite challenging and in many cases more difficult than procuring direct materials due to the many intangible factors that are present in services, and the lack of well established tools for analyzing the services spend.

The Opportunity. Data suggests that the typical firm has not re-allocated staff resources to match the shift in purchasing patterns from direct materials into services. A huge opportunity to create significant competitive advantage exists for organizations that improve the purchase of services. In addition, given the tremendous changes that have occurred in services, firms also need to carefully reconsider the skills and tools that services procurement departments should possess.

Objectives. The objectives of this paper are to provide the reader with:
- Facts about growth in the importance of services spend
- Information about where and how services spending abuses occur as well as the magnitude of abuses
- Tools and recommendations for significantly improving and controlling services purchasing

Our presentation will provide greater depth and explanation in these areas.

Trends in Services Purchasing. In 2002 CAPS Research investigated trends and opinions in services procurement. This research was based on the responses of 115 organizations located in the United States, Canada, Mexico, the Netherlands and Great Britain. Respondents were both public and private sector firms in a variety of industries. Mean sales were $7.36 billion with purchases averaging approximately 40% of total sales. Purchased services averaged 33%, with a maximum of 86.35% of total spend. It is likely the the estimates for services purchasing are underestimated to some extent, since service spending is often decentralized and fragmented with a minority of purchase dollars flowing through formal supply management systems. For most service categories, less than 60% of spending flows through formal systems and processes, as shown in Figure 1. Decentralization and increased levels of outsourcing and off-shoring create an increasingly difficult job for services procurement staff. Compounding the situation, Services spend has been growing rapidly; for the numerous firms,
services and indirect procurement spending is approximately equal to direct spending and growing (Atkinson, 2004).

Despite the difficulty of purchasing services, supply management often has limited impact on purchasing of services.

The CAPS findings further suggest that the procurement of services presents a challenge when compared to the purchasing of direct goods. None of the respondents felt that services procurement was less difficult than purchasing direct materials and over two thirds felt that services procurement was difficult or very difficult. Basic procurement tasks such as clearly defining what will be purchased, understanding how to compare services offerings, or how to normalize the differences between services that use significant amounts of human capital are significant challenges.

Additionally, over 75% of all respondents considered managing purchased services to be more difficult than procuring direct materials. Verifying compliance to procurement processes as well as contract compliance is challenging when procuring services due to the high number of transactions, often originated from many sources. Services are difficult to inspect after the fact and often use very vague statements of work. For pure services, ambiguity is likely regarding the quality of the outcomes, unless the contract has been very carefully developed and includes measurable key performance indicators.

**Abuses in Services Spending.** Table 1 outlines four major types of non-compliance that services groups need to manage. The decentralized nature of the buying community (“users”) creates an opportunity for orders to be placed with an unapproved supplier or for the supplier to deliver a non standard service. In contrast, such defects are exceptional when procuring direct materials.
Table 1: Types of Service Non-Compliance

- Unapproved Supplier
  - Order placed with unapproved supplier
- Approved Supplier, Wrong Specification
  - User order non-standard service
  - Supplier provides incorrect service
- Approved Supplier, Wrong Price
  - Supplier overcharged for service
- Approved Supplier, Other Defect
  - Multiple billings, invoicing error, etc.

For example, a financial services company reported after extensive auditing that their actual temporary labor prices were 6.2% higher than contracted. This range is typical and is indicative of all procured services. CAPS data shows that procured services are typically 33% of total procurement and it is not unusual for a firm to procure more than 60% of revenue (Hughes, 2003). As such, a typical firm could expect for compliance defects in services procurement to be costing them nearly 2% of total revenue. In many organizations this amount is material and would be addressed aggressively if the loss potential were transparent.

Unstated and Incorrect Assumptions. For procuring services, the consequence of organizing using incorrect assumptions is a reduction in firm’s overall effectiveness. For many services, the market is not efficient or competitive compared to a “should cost” model. Prices may be significantly above market. These situations allow very high margins for the supplier. Due to our lack of knowledge and systems for purchasing services, we operate with many limiting assumptions when purchasing services.

Unstated purchasing assumptions include:
  - Procurement and the economic buyer know, in advance, the most efficient bundle of services to request.
  - Procurement’s role during the sourcing process is to create a fair, controlled marketplace in which to determine the market-clearing price.
  - There is little value in collaborating with supplier on how they deliver the services required. The most efficient supplier will win the business.
  - Over time, the supplier will work to reduce the costs of providing services, and the buyer can earn a portion of that economic value through periodic re-sourcing of the commodity.

Incorrect control assumptions include:
  - The beneficiary of the services won’t approve the invoice unless it meets the terms of the contract
  - Adequate investment in controls is made by supplier
  - Outsourced controls (e.g. freight audit / payment firms) can correct these gaps

The Resource Bind. Given the rapid growth of outsourcing and its complexity, we expected the resources devoted to services procurement departments to increase significantly. Surprisingly, CAPS research benchmarking (2002) shows that services buyers have over twice
as many active suppliers as their counterparts in direct procurement (74 vs. 32). Such resource allocation problems have been observed and documented in many organizations. We will discuss a possible cause, called “the contingent power model,” during the presentation.

Consequences of the Resource Bind. A lack of resources, tools and skills within services procurement departments may cause expensive problems to appear. As shown in Figure 1, high levels of maverick spending and other compliance defects are common for procured services. Complicating matters, users may buy services with software tools provided by service providers. For example, package shipping companies and temporary labor firms provide buying systems for use by companies buying shipping or labor services. Adoption of supplier tools results in users being “sticky” toward these service providers because of their familiarity with the buying tools, causing a loss of power for the procurement groups and encouraging rouge spending.

Often, there is very limited understanding of the cost drivers and structures associated with procured services. The complexity of service cost structures and delivery models, coupled with resource shortages in services procurement departments, may cause overworked services buyers to depend on the supplier’s sales staff. Because of mis-aligned incentives, these dependencies may reduce the cost of the procurement group at the expense of unfavorable prices.

Behavioral Examples. Following are example behaviors that services suppliers exhibit which result in economic loss to their customers. In many cases these behaviors can be mitigated by increasing the resource base of services procurement departments and adopting better tools. Controlling these service supplier behaviors during the supplier selection, contracting and delivery management phases can be time consuming and expensive.

Suppliers can usurp procurement leverage by taking rebates, special pricing, and available stocks in times of shortage that otherwise would have been captured by their customers. An example was reported in the Wall Street Journal (9/17/03). The US government and others filed suit that certain audit firms systematically “billed clients full fare for airline tickets, hotels, and car-rental, while pocketing undisclosed rebates and volume discounts.” Another related behavior is for consulting firms to arrange with airlines to change higher prices for “client paid” and significantly lower rates for “non-client” travel. Given the complexity and difficulty associated with specifying the service level agreements needed to control the large and evolving number of loopholes that exist in services relationships, it is little wonder that most services procurement groups are unable to adequately protect their supply chains.

Another behavior we have observed is for service providers to quickly pass through price increases for consumed materials and inputs and delay pass through of price decreases. Similarly, service suppliers have also been observed to be very slow in paying bills to sub-suppliers. Another challenge for services procurement departments is ensuring that what was contracted for is actually delivered. Other costly procurement process defects are caused by the common practice of summary invoicing for services. Unlike direct materials that can be controlled via three way matching, services are often controlled using a two way match with summary invoices. Summary invoices are used to reduce the resource burden in the services procurement and AP groups at the risk of increased costs.
Consequences: Resulting Flaws in the Services Competitive Bid Process. While a competitive bid sourcing process can provide good insight to the current market pricing for a predefined service, it rarely provides insight into the underlying dynamics of the supplier’s cost structure, or the relative costs of the various activities the supplier is taking on. In essence, competitive bidding may tell you what a service does cost, but it does not tell you what a service should cost.

This lack of visibility to the inner workings of a services supplier leads to limited, win-lose negotiations, typically focused on price and market competition alone. Price-only negotiations stem from the premise that a vendor’s operation is efficient and that procurement’s value-add is focused on identifying the most efficient supplier by eliminating the “excess profit” from supplier proposals. This approach is short sighted, particularly when procuring services, and ignores the very real fact that suppliers incur costs for (and charge for) certain activities that may not be relevant or even value-adding to an organization’s specific situation.

Lack of visibility and control may result in the firm not getting what was paid for or in getting a competitively inferior price. The firm may lose the opportunity to effectively explore alternative sources when users are strongly influenced by the service providers. Lastly, lack of adequate resources and processes may prevent firms from fully leveraging supplier’s ideas to improve service delivery, value and cost.

Putting Things Right: What To Do. We have four main suggestions:
1. Allocate appropriate resources – relative to economic return - to your services procurement departments. You can’t take on more without the right level of staffing. In most cases, this will be an incremental process where you prove yourself and are thus awarded more resources.
2. Measure effectiveness and ensure proper business controls. This is a matter of getting the right tools developed and in place. It includes the following:
   o Conduct periodic supplier audits to correct compliance errors. Such audits should not simply be “punitive,” but should address the underlying issues that create the errors.
   o Install systems to inspect transactions to control compliance errors.
   o Develop better services contracts that contain:
     ▪ Specific payment milestones
     ▪ Clear SLAs and measurements
     ▪ Define the meaning, causes, and penalties of non-compliance
3. Increase the professionalism of services purchasing
   o Develop and manage to service “should-cost” models, similar to lean manufacturing. Yes, this takes time. You should start with areas where you have some information, and you believe that there is opportunity to improve.
   o Disallow services purchasing without the involvement of service professionals to help develop contract, SLAs, and measures.
   o Develop user friendly contract templates for small, non-recurring service buys to add value to end users where risks and leverage gains are minimal. Have the use of this template overseen by procurement.
4. Lastly, put your best people in services procurement! You need some trailblazers to set the standard, people who know what is possible and can develop a vision for formalizing services.
REFERENCES

U.S. Department of Commerce (2003), International Trade Administration, Office of Service Industries, March.