



## REDUCING THE COSTS OF PURCHASED SERVICES

### What Strategies Are Available to Help Reduce the Costs of Purchased Services?

#### ABSTRACT

Services spend is often considered a secondary target for cost reduction, yet studies suggest that services spend can account for 30 percent to 70 percent of an organization's total purchase dollars. Fearon and Bales (1995) state that "the opportunity to increase profits through more effective purchasing probably is greater in the buying of services than in the purchase of goods." A logical step in overall cost reduction strategies is to focus on purchased services. A review of the available literature revealed a number of strategies that organizations can use to reduce the cost of purchased services, with each strategy producing varying results. Some potential strategies include: exploiting volume aggregation; committing to supplier development and relationship management; adopting integrated sourcing and procurement strategies that increase an organization's control of services purchases; recognizing the differences in complexity between purchasing materials and purchasing services to assign the most appropriate supply professionals to each category; exploring opportunities to participate in group/consortium buying; potentially outsourcing some or all of the responsibilities of purchasing services to a third party; and using reverse auctions. Each buying organization should carefully select the cost reduction strategies it will use based on its particular needs, strategic goals and competencies.

---

# REDUCING THE COSTS OF PURCHASED SERVICES

## INTRODUCTION

Services purchases consume a large portion of an organization's spend. A study sponsored by CAPS Research in 2002 found that the average spend for services among 104 large organizations was one third (33 percent) of the total purchase dollars. Much effort is expended to cut costs for purchased materials and direct goods, but less emphasis is placed on cutting costs of purchased services. An increasing number of organizations have realized the potential cost savings that can result from focusing on cost cutting efforts in the services spend area. A study by Denali Consulting showed that when cost savings are pursued, savings on services ranged from 10 percent to 29 percent versus an average of 5 percent to 17 percent for other commodities or materials (Stradford and Tiura 2003).

Numerous strategies exist that a firm can employ in order to reduce the costs of purchased services, depending on organization needs, goals, and objectives. This report covers a variety of strategies that were identified in a review of the literature. These strategies include volume aggregation, a commitment to supplier development, an integrated sourcing and procurement strategy to increase control over services purchases, determining optimum staffing assignments that assign the most appropriate supply management professionals to services purchases, consortium buying, outsourcing the purchasing of services to a third party, and reverse auctions.

## VOLUME AGGREGATION

In many organizations, different strategic business units are buying the same type of products/services from different suppliers or even the same type of product/service from the same supplier at different prices. Organizations can be missing a large amount of potential savings because these purchases are not being consolidated into one buy that can be leveraged across the entire organization resulting in a lower purchase price. Volume aggregation refers to the process of collecting and categorizing purchasing spend to determine what goods and services are being purchased throughout the entire organization and from which suppliers they are being purchased. Once the overall spend is analyzed, the buying organization can identify goods and services that might be channeled through key suppliers to achieve maximum leverage (Carter et al. 2003).

Developing tools to gather and analyze purchasing spend data is the foundation of this effort. Software tools and other automated purchasing systems can greatly assist in this effort. Once the buying organization is able to identify clearly what is being purchased, by whom and in what quantities, services with high expenditures across a number of suppliers can be identified. The volume of purchases for those services can be used as negotiating leverage with suppliers to achieve price discounts and other benefits. You may also be able to identify suppliers that provide a number of different services that can be bundled together for increased leverage with those

particular suppliers. Product and service standardization opportunities may also become apparent as a result of the volume aggregation efforts. Similar products or services with only slight differences can be identified and standardized for further consolidation.

The experience of Delta Airlines provides a good example of an organization obtaining cost reductions through successful data collection and analysis. Delta had several different hubs acting as individual business units by contracting and purchasing their own services and supplies. Delta installed a software system that categorized spend across the entire organization and identified areas where it could use its buying power to leverage discounts with suppliers. Delta took these findings and arranged contracts that resulted in a savings of \$11 million on hotel rooms alone in a three-month period (Konicki 2002).

## COMMITMENT TO SUPPLIER DEVELOPMENT

Supplier development and relationship management efforts can lead to closer cooperation and trust between the buying organization and its suppliers. Organizations are realizing that they must have a globally competitive supply chain to be globally competitive. Supplier development should follow after a company is able to demonstrate effective internal processes and capabilities (Krause and Handfield 1999).

According to Krause and Handfield (1999), there are 12 steps to developing a world-class supply base, which can be categorized into four stages:

### Stage 1: Identifying/assessing/rationalizing the supply base

1. Identify strategic supply chain needs
2. Search for competitive suppliers
3. Establish performance metrics and assess suppliers
4. Supply base rationalization

### Stage 2: Problem-solving development

5. On-site risk assessment by cross-functional team
6. Problem solving to eliminate suppliers' deficiencies

### Stage 3: Proactive development

7. Establish open relationship through feedback and information sharing
8. Systematic supplier development: direct involvement activities; incentives and rewards; warnings and penalties
9. Maintain momentum

### Stage 4: Integrative development

10. Supplier integration in new product/process development
11. Establish performance improvement in second-tier suppliers
12. Establish integrated supplier network

---

# REDUCING THE COSTS OF PURCHASED SERVICES

As an organization moves through each stage with key suppliers, the developing relationship can lead to cost cutting opportunities through a variety of means. When buying organizations proactively participate in discussions with their suppliers, it becomes more evident to the suppliers that the buying organization has a vested interest in the relationship. Greater levels of trust and cooperation develop, which can lead to an open relationship where buying organizations and suppliers work together to reduce costs in ways to benefit all parties involved. With increasing levels of cooperation and communication, buyer and supplier can identify ways to cut transaction costs, reduce waste and eliminate non-value-added activity. You may be able to identify additional services or products that certain suppliers can provide for you as a result of closer ties with them. This could lead to further savings opportunities through volume aggregation.

## INTEGRATED SOURCING STRATEGIES

A study by Fearon and Bales (1995) showed that the purchasing department did the buying for only 41 percent of the total purchase dollars in the organizations surveyed. The effectiveness of the 59 percent of purchases that is handled by other departments should be examined more closely. Integrated sourcing strategies aim to increase the level of purchasing control and compliance by increasing the involvement of the purchasing department in buying decisions. Increasing the involvement of the purchasing department can be a significant challenge, especially where other departments may see it as an intrusion. However, the potential for savings on services purchases is large, and other departments should eventually come to realize that purchasing can bring much to the table.

Stradford and Tiura (2003) identify common areas of savings leakage in services purchases that can be addressed through integrated sourcing strategies. Areas that tend to leak potential savings stem from the breakdown of communication between the supply management department and other areas in the company. The common areas of savings leakage are: purchasing compliance, contract compliance, financial controls, and payment efficiencies. Cost reductions can be realized by addressing these areas and plugging the leaks.

### Purchasing Compliance

With regard to purchasing compliance, the purchasing department is much more likely to be bypassed when services rather than materials are being purchased (Smeltzer and Ogden 2002). This lack of purchasing compliance allows other individuals within the company to make purchases that may lack the potential cost benefits of following logical purchasing processes. When organizations gain a clear understanding of who is purchasing what, when, where and how much, management can install procedures to deter and control maverick spend (Carter et al. 2003). Fearon and Bales (1995) state that top management has the responsibility of seeing that purchase dollars are spent effectively. Where purchases are made outside of the purchasing department, an evaluation

should be made to determine if this is the most effective way to handle them. The purchasing function has much to contribute, and the employment of logical purchasing processes can result in substantial savings in a number of areas. Top management should determine the best approach for increasing purchasing compliance in the organization. This process could include setting up a chain of command to ensure that purchasing protocol is followed (Carter et al. 2003).

“Power spenders,” high-ranking individuals outside of purchasing who control large amounts of services spend, can be a big problem. Because of their position of authority in the organization, it may be difficult to get them to comply with purchasing policies. However, properly training power spenders can be an important key in controlling their spend. This training should include information on general sourcing strategy and the use of appropriate tools. Once trained on the benefits of logical purchasing processes, power spenders will often become champions of the process and help others to understand the value of strategic sourcing (Carter et al. 2003).

### Contract Compliance

Contract compliance is another source of potential leakage; it exists where the organization may have negotiated favorable rates from suppliers for certain services but buyers may not be aware of the arrangements or may choose to ignore them altogether. Preferred supplier lists should be made available to each individual in the organization with the authority to buy so that the most favorable rates can be obtained. The objective of these preferred supplier lists is to capitalize on lower negotiated rates so that corporate funds are not being wasted. Executive mandates or policies could be issued that require the use of preferred suppliers or some sort of advance approval for purchases “off contract.” The additional work involved may make the allure of maverick purchasing no longer “quicker and easier” but actually more time consuming than going through standard purchasing channels.

An advantage of contract compliance is that it can lead to more opportunities for volume aggregation as services spend that previously went off contract is brought back in. The additional volume may lead to additional leverage and negotiating power with suppliers. An approach to enforcing contract compliance is to integrate accounts payable operations into supply management. This arrangement gives supply management the power to withhold payment for services that were bought off contract. In order to have the bill paid, the SBU that made the purchase is forced to speak to the CFO (Carter et al. 2003). Electronic catalogs or automated purchasing tools may also increase contract compliance.

### Financial Controls

The lack of appropriate financial controls can contribute to substantial leakage of savings because services purchases are historically known for over-billing and cost overruns. One of the challenges of services purchases is that the buying organization needs to verify services delivery and prices with agreed-upon terms, expense limits and change order terms. All

---

## REDUCING THE COSTS OF PURCHASED SERVICES

contracts need to be evaluated against what was actually performed by the supplier and what the company was billed for. Stradford and Tiura suggest that in some service categories, over-billings are found on as many as 60 percent of invoices. When organizations are not verifying the validity of these invoices, they could be losing thousands of dollars a year or more. Integrating accounts payable into supply management may increase the ability of your organization to catch over-billings. Automated requisition/purchasing processes can also be employed to perform invoice matching and verification. Besides saving time and money, automated processes allow supply managers to focus on the strategic issues of buying instead of the tactical.

### Payment Efficiencies

Finally, the lack of payment efficiencies can cost any firm potential savings. Many organizations have long and costly service payment schedules that may cause them to miss the opportunity to reduce costs by paying early and utilizing early payment discounts. Again, automated systems that save time and effort may also save money by speeding up the payment process to take advantage of these discounts. It is easy to overlook a 1 percent to 2 percent discount, believing that the savings are too small to make a difference. The reality is that when this discount is spread over millions of dollars of spend, it can have a major impact. Stradford and Tiura suggest that buyers negotiate early payment discounts with suppliers and that organizations develop payment processing systems that will operate quickly and efficiently to take advantage of the discounts.

### An Example

A good automated purchasing system will promote purchasing and contract compliance, use appropriate financial controls to ensure accurate billing and take advantage of early payment discounts. The following example illustrates how automated purchasing systems can be implemented to promote an integrated sourcing strategy. An organization has contracted with a supplier for the purchase of various information technology (IT) services. An employee with an IT problem in the organization can send an electronic request to the purchasing department detailing the problem. The purchasing department then electronically forwards the details of the service requirement to the preferred IT supplier. After the IT provider performs the service, it completes and submits through electronic means the necessary invoice form stating what work was done and the cost of the service. Once purchasing receives the invoice, an electronic payment can be sent to the supplier. The IT problem is resolved, and all information related to the transaction is trackable through the automated system.

## ASSIGNING SERVICES PURCHASES TO THE RIGHT PEOPLE

Another important strategy to reduce the costs of purchased services is to assign the most appropriate supply

management professionals to this task. Smeltzer and Ogden (2002) conducted a quantitative survey where 82 purchasing managers with an average of nearly 10 years of purchasing experience were interviewed to understand the perceived differences between purchasing services and purchasing materials. It was discovered that those surveyed and interviewed did perceive some differences between the two, with 63 percent of respondents indicating that services purchases were more complex. A study by CAPS Research (2003) showed similar results, with 70 percent of those surveyed reporting that buying services is more difficult than buying goods. Additionally, 75 percent of respondents reported that they considered managing services as more difficult than managing goods. Respondents also reported lower levels of competence in sourcing, procuring and managing services as opposed to goods. Respondents were asked to rate their organization's level of competence for sourcing goods and services on a scale of 1 to 5 (1 = lowest; 5 = highest). The weighted average for goods was 4.50 compared to 3.65 for services.

Smeltzer and Ogden conclude that services are a complex buy that becomes less complex with experience. They go on to state that "Because of these differences between buying services and buying materials, it may be possible that a person who performs well with one type of buy may have difficulty with the other type." The implication is that if one type of buy is more complex than the other, then staffing, training, employee reward, and employee evaluation systems should reflect these differences.

On the other side of the coin, the general view of top management toward the purchase of services contradicts the view of those who actually do the buying. Top management frequently perceives that the purchase of goods is more complex than the purchase of services. This misperception can often lead to the practice of assigning services purchases to less experienced professionals to help them gain valuable experience before assigning them to the more "complex" task of purchasing goods. The results of Smeltzer and Ogden's research show that this practice does not appear to be in the best interest of the organization. The greater complexity of services purchases suggests they are best left to the more skilled and experienced professional.

Organizations that carefully assign service buys to their most qualified and experienced staff members are likely to find potential rewards that include reductions in cost. An individual that participated in focus groups led by Smeltzer and Ogden noted, "Top management, and that includes purchasing management, does not understand the potential waste from a bad service contract."

One of the reasons supply managers cite for the increased complexity of services purchases is the frequent lack of adequate specifications and measurements. Technical specifications are frequently available for goods purchases, and performance of the goods against those specifications is generally easy to measure. For services purchases, an effective statement of work (SOW) ensures that the buying organization

---

# REDUCING THE COSTS OF PURCHASED SERVICES

receives what it is requesting from the supplier, pays a fair and reasonable price and spends a minimum of effort on administrating and managing the contract (Sickinger 1997). However, a comprehensive SOW that clearly establishes the specifications for the service may be difficult to write and is a step that is often overlooked. The parties requesting the purchase of services seldom give specific details to allow purchasing staff to create an effective SOW, so they are frequently left to deal with the ambiguity all on their own. For large services purchases, it may be helpful to assign cross-functional teams the responsibility of creating specifications to aid purchasing staff in the creation of effective statements of work (Smeltzer and Ogden 2002). This may help to decrease some of the complexity associated with services purchases.

## GROUP/CONSORTIUM BUYING

Consortiums have gained popularity in recent years because they allow different organizations to combine their purchases for increased volume and leverage with suppliers in an effort to reduce prices (Carter et al. 2003). Consortium buying can be very beneficial for smaller firms or organizations that purchase a low volume of particular services. These firms may not be able to generate enough volume to negotiate low rates effectively on their own, but when their purchases are grouped with a number of other firms', the combined volume can add up to significant volume and buying power.

One of the problems associated with consortiums is getting all members involved to agree collectively on what is to be purchased (Carter et al. 2003). Since consensus among the group can be challenging to achieve, negotiation can be very lengthy and may even end in the dissolution of the consortia. A possible method for avoiding this problem is to appoint a third-party management team that specializes in the type of products/services needed. The third-party team can independently determine the optimal choice of services for purchasers to buy through the consortium. Third-party groups also help to ensure that participants do not violate antitrust laws or Safetyzone legislation that relates to consortiums (Leddy 2002).

## OUTSOURCING

Another approach to reducing costs is outsourcing the responsibility of purchasing services to a third party. This is a controversial approach that may cause your supply management staff to be concerned about potential job losses and your organization's leaders to be concerned about handing over some portion of organizational control to a third party. Decisions to outsource any part of the purchasing function, regardless of the strategic implications of the services or goods to be outsourced, are strategic decisions and should be made with great care (Carter et al. 2003).

To outsource the process of purchasing services effectively, sourcing partners should have the inherent capability to track spend for volume aggregation efforts, a

technology infrastructure, logical supply management processes to follow, and strong sourcing expertise (Carter et al. 2003).

Harley-Davidson is an example of an organization that received great benefits from outsourcing. In early 1999, Harley-Davidson outsourced its entire indirect spend to three suppliers. These three suppliers are responsible for ensuring that all of Harley-Davidson's indirect purchasing requirements are fulfilled, either by providing the needed materials/services themselves or by acquiring them from other suppliers. In the first year, the move saved Harley-Davidson an estimated \$4 million, when projected savings had been expected to be only \$3.2 million (*Purchasing* 2000).

## REVERSE AUCTIONS

A reverse auction is "an online, real-time dynamic auction between a buying organization and a group of pre-qualified suppliers who compete against each other to win the business to supply goods or services that have clearly defined specifications for design, quantity, quality, delivery, and related terms and conditions" (Beall et al. 2003). The popularity of reverse auctions continues to grow and is expected to grow at a rate of 10 percent to 15 percent per year (Carter et al. 2003).

Reverse auctions provide several benefits to the buying organization. The major benefit is the potential to buy goods and services at a lower price. Some firms are reporting an average price savings of 10 percent to 20 percent (Carter et al. 2003). Reverse auctions can create markets for goods or services where none previously existed. They can also increase the reach of buyers to allow them to find potential suppliers worldwide in a cost effective way. Many organizations also report a significant cycle-time reduction of as much as 40 percent over traditional sourcing processes (Beall et al. 2003).

Opponents of reverse auctions caution that the process prevents the establishment of long-term relationships with suppliers and focuses the transaction solely on the purchase price. Some warn that the total cost of goods or services purchased through reverse auctions may actually be higher in the long run because of the lack of a developed buyer-supplier relationship (Beall et al. 2003).

Not all services or goods are appropriate candidates for reverse auctions. The major attributes of biddable goods or services are:

- Items can be clearly specified and translated into prices a supplier will commit to charge the buyer.
- There is a strong likelihood that the current price is sufficiently higher than the market price.
- The cost of switching suppliers is acceptable.
- A sufficient number of qualified suppliers is available.
- Qualified suppliers are willing to participate in the process. (Beall et al. 2003)

---

## REDUCING THE COSTS OF PURCHASED SERVICES

Carefully consider the appropriateness of reverse auctions for each purchase before you make a commitment to their use.

### **CONCLUSION**

There are several different strategies and tools that a buying organization can use to reduce the cost of purchased services. Each buying organization will have to determine the best strategies to use based on its own unique factors, strategic goals, and core competencies. Strategies that work well for one organization may not work effectively for another. Carefully evaluate the options available to you and choose the strategies that fit the particular needs and situations of your organization.

Some of the money saving strategies identified in this paper include tracking spend more closely to identify opportunities to take advantage of volume aggregation; being involved in supplier development efforts to improve relationships with key suppliers; developing integrated sourcing strategies that decrease maverick buying by promoting purchasing compliance, increasing contract compliance, increasing the level of financial controls and improving payment efficiencies; assigning the tasks of services purchasing to the most appropriate staff members; exploring group or consortium buying opportunities; outsourcing some or all of the services purchasing responsibilities to a third party; and using reverse auctions appropriately. By effectively using some or all of these strategies, any organization can begin to realize significant savings on its services spend.

## REFERENCES

- Beall, S., C. Carter, P. Carter, T. Germer, T. Hendrick, S. Jap, L. Kaufman, D. Maciejewski, R. Monczka, and K. Petersen. *The Role of Reverse Auctions in Strategic Sourcing*, CAPS Research, Tempe, AZ, 2003.
- CAPS Research. "Managing Your 'Services Spend' in Today's Services Economy," Tempe, AZ, 2003
- Carter, P., S. Beall, C. Rossetti, and E. Leduc. *Critical Issues Report: Indirect Spend*, CAPS Research, Tempe, AZ, 2003.
- Fearon, H.E. and W.A. Bales. *Purchasing of Nontraditional Goods and Services*, Center for Advanced Purchasing Studies, Tempe, AZ, 1995.
- Krause, D.R. and R. B. Handfield. *Developing a World-Class Supply Base*, Center for Advanced Purchasing Studies, Tempe, AZ, 1999.
- Konicki, S. "E-Sourcing's Next Wave," *InformationWeek*, March 18, 2002.
- Leddy, E. "Consortium Procurement: A Look Inside," *Inside Supply Management*, July 2002.
- Purchasing*, "Harley Davidson Looks to Suppliers for Cost Savings," April 20, 2000.
- Sickinger, J. "Writing a Complete and Effective Statement of Work," *NAPM InfoEdge*, November 1997.
- Smeltzer, L.R. and J.A. Ogden. "Purchasing Professionals' Perceived Differences Between Purchasing Materials and Purchasing Services," *The Journal of Supply Chain Management*, (38:1), Winter 2002, pp. 54-70.
- Stradford, D. and D. Tiura. "Keeping the Savings You Thought You Were Getting in Services Sourcing," 88<sup>th</sup> *Annual International Supply Management Conference Proceedings*, The Institute for Supply Management, Tempe, AZ, 2003.