Douglas Austin
President
StrategicSource, Inc.

Doug Austin is the founder and President of StrategicSource, Inc., the leading provider of Spend Management Services(strategy, spend mapping, sourcing, process improvement and audit) for the automotive and truck dealerships, education, hospitality, service and manufacturing markets.

Doug has over 35 years of line, staff and executive management experience in Spend Management, Purchasing, and Supply Chain Management in various vertical markets including airline, retail, manufacturing and services.

Doug has been married to Peggy for 40 years, the father of three children and the grandfather of nine. Doug is a proud veteran of the U.S. Marine Corps, a graduate of the University of St. Thomas, and a speaker at various conferences and 20 Groups. Doug is also a trainer, consultant, and a business owner.

Where are the Cost Savings?

Organizations frequently embark on various cost reduction initiatives across their enterprises. Some organizations have Purchasing Departments and their role is typically to get the right product or service, to the right location, at the right time at the best cost. In either case, whether your organization is centralized with a Purchasing Department or decentralized with various departments working on cost savings initiatives, one common frustration will normally occur. Where are the cost savings? How come we can't see them? Are they really there? Frustration can occur unless some visibility is shed on the challenges inherent in this process.

Profit and Loss Statement Challenge

Most of us would assume that cost savings generated would be easily identified on the Profit and Loss or P & L statement generated each month. Any reduction in price and spend should be easy to identify on the P & L right? Wrong!

The typical Profit and Loss statement is a summary document. While all P & L's are summary documents, they typically contain about 25 lines of expense to review. The reality however is that most companies spend dollars in between 60 to 130 expense categories depending upon the industry. So, how are those expense categories represented on the typical P & L? They are typically summarized into the most appropriate line on the P & L.

Remember……supplies and services might number as many as 130 expense categories in your organization, so the spend and savings you have obtained are going to be aggregated with many other categories represented in the summary P & L document which is represented by about 25 lines on the document.

Example – Why Don't I See the Office Supply Savings?

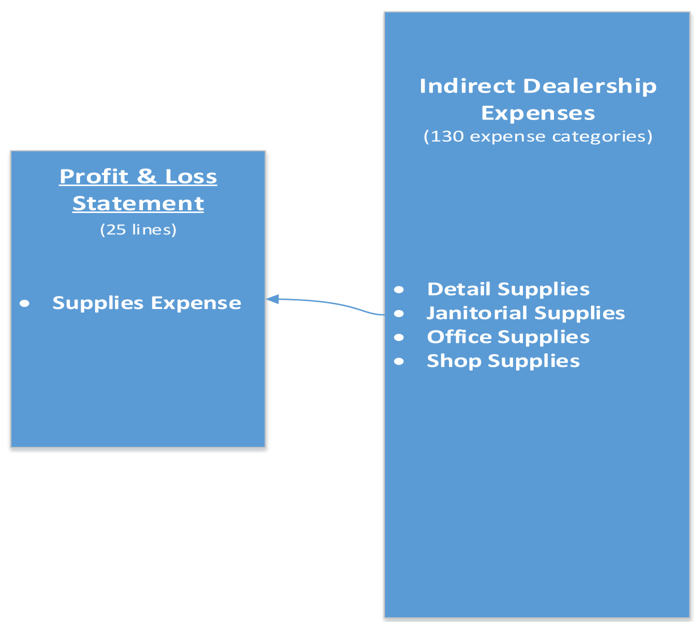
Your organization reduced your office supply pricing by 25% and expect to see average savings of $24,000 per year on office supplies. You have verified that all employees are using the designated supplier, at the new prices, and the suppliers are selling the product at the agreed pricing. So…..the office supply spend is now blended into a category on your P & L entitled “Supplies”. The spend for “Supplies” this month did not decrease, but actually increased……. how can that be? There are a number of possible explanations including the following:

- **Blending Problem** - Shop supply spend or some other category which is part of this Supplies category on the P & L may have increased this month, hiding the effect and benefits of the new office supply savings.
- **Consumption Problem** - While the pricing of office supplies has improved by 25%, it may be that your consumption of those supplies increased…..using more product than you did before
- **Supplier and Mix Problem** – While the negotiated pricing is in place for designated items, your employees might be purchasing the “wrong” items……. they might be ordering the brass stapler at $25.00 versus the steel stapler at $5.00. They might also be using the wrong supplier. Or., said a different way, you have an internal compliance issue.

If any of these scenarios occur, the cost savings you achieved are legitimate, but the issue is either a reporting problem (P & L) or a management issue (usage or compliance).

The Cost Savings Reporting Challenge

“The aggregation of 130+ expense categories into a typical 25-line P & L will often mask the results of a successful cost reduction effort at the category level…. leaving category audits as the only viable alternative to verify cost savings.”



The Iceberg Principle – Why Typical Cost Reduction Efforts Fail and Savings Can’t be Found

To the novice, sourcing seems pretty easy. Go out, find a supplier who has the product or service you want and then engage in a negotiation battle over the “price”. When you obtain the item cheaper than other people you know, or at a number you feel good about, you call it good. The fire is out…..move on to the next business problem.

This phenomenon is commonly referred to as the Iceberg Principle of Purchasing. The “buyer” in this case sees only the small portion of ice above the water line and that is where they spend their time. But the threat, the problem…..and the opportunity if approached in the right way is not only what can be seen above the water line, but also what is not seen below the water line. Those that focus only on price are becoming victims of the Iceberg Principle. They are forgetting about the impact of all of the other aspects of the purchase that in total, could have much more impact than just the price alone. Making sure the requirements are right, the spend is known to utilize the right leverage, price and terms are favorable, the correct order process is in place, controlling for consumption, overall supplier base and payment processes are absolutely imperative. If the "Buyer" is focusing only on that which is above the water line and ignoring everything else, the cost savings opportunity overall are minimized.

Iceberg Principle

What Elements Impact Overall Cost Savings?

When Purchasing Departments or individuals embark on cost savings initiatives, it is a good idea to understand the many components that have an impact on cost, and ultimately the category spend and cost savings in an organization. The following items need to be controlled for and usually can be controlled if the program is set-up correctly on the front end.

- **Category Usage** – It is possible that the expenditure for a service or supplies may not be necessary to the organization at all. Eliminating that expense would be an obvious way to reduce the cost.
- **Business Requirements** – The client defines what is "needed" vs. "current or wanted". Do we really need our waste picked up three times a week when maybe two times will work just fine?
- **Pricing** – Quoted or negotiated pricing that is locked and is locked down for extended periods of time is the best approach. Long term pricing is the best way to provide sustainable savings over the long term.
- **Business Terms** - Favorable terms - 2% 10 payment terms, freight charges, service levels, etc. should always be negotiated as part of the transaction.
- **Item or Service Selection** – High usage, least cost items should normally be purchased vs. higher cost alternatives. Having approval processes in place to control against higher cost substitutions are requested is generally a good idea.

- **Supplier Specified Order Process** - Supplier driven order processes can provide additional discounts when proper processes are followed. If correct processes are not followed, those discounts will not come through and would hide expected cost savings.
- **Consumption** – The quantity of items consumed will impact the overall spend and could mask any negotiated cost savings achieved at the item level if usage is greater than anticipated.
- **Correct Supplier** – If the designated or Preferred Supplier isn't being used by the employees, the negotiated savings will not be achieved.
- **Supplier Payment Process** – Most organizations can avail themselves of additional cash discounts if they pay the supplier with a credit card vs. a check. Payment card related cost savings are also auditable and easy to validate.

  Any or all of the above elements of a purchase will have a material impact on the actual cost savings achieved and provide a much better result than a pure focus on price alone. Most of the elements can be controlled and delivered through a proven 8 step purchasing process across the organization. Management still has an obligation however to make sure employees are using the right suppliers, buying the right items and following the established processes.
- **Audits – The Best Way to Validate Cost Savings** So far, we have reviewed the spend management elements that will yield long term, sustainable cost savings. We understand that negotiated cost savings can and will be masked by the construction of the profit and loss statement given the summary nature of the document. We have also discovered that many elements of a cost savings initiative need to be controlled to ensure that the savings materialize. So, what then is the best way to validate cost savings for supplies and services across an organization?

Category Audits Will Validate Cost Savings

A category audit can be used to validate cost savings in any expense. In our experience, there are four components of a category audit, all of which are critical to the integrity of the audit***. Cost savings will be achieved if four things occur……. the pricing is right, the right supplier is used, consumption levels are correctly realized and finally, if the right items are being purchased.*** If those things happen, then the savings will occur regardless of whether it can be seen on the P & L or not. Those audit elements are as follows:

- **Supplier Compliance** – Reports on supplier price and business term compliance against expectations or the original contract.
- **Client Compliance** – This part of the audit reports on whether the organization is using the right supplier, the designated or Preferred Supplier. This audit will also validate whether the expected spend is observed. This is the money question. Is our overall spend lower and meeting our original projections or not? If not, the organization could be using suppliers other than those designated and that needs to be determined and corrected.
- **Item Compliance** – This part of the audit verifies whether the right items are being consumed…. the high usage items that were negotiated and recommended. These "core" items or selected services should be consumed versus the higher cost alternatives that might be available.
- **Consumption** – If the organization consumes more of a service or a supply, the costs will increase, and cost savings will be hard to find. Obviously if business levels increase, greater consumption is justified and welcomed. If, however, business is flat or declining, consumption should follow the same trajectory.

"Category audits can confirm both supplier compliance and user compliance and are the best method to validate cost savings results."

Audit Type	Items Audited	Accurate Items	Item Accuracy
Supplier Price Compliance			

Audit Type	Expected Spend	Audited Spend	P.S. Compliance
Preferred Supplier Compliance			

Audit Type	Non-Core Items	Core Items	Core Item Usage
Core Item Compliance			

Audit Type	Non-Core Items	Core Items	Core Item Usage
Consumtption - usage			

If your category audit consists of these four components……. rest assured, your cost savings are there. The savings are real and measurable, and you just proved it with this simple audit. Even though the savings are hidden or buried in various financials……..you can't dispute that prices are lower, terms are better, the spend in that category is lower and the limited spend dollars are being used with the most cost effective items.

Summary

We started this paper with a question…." Where are the cost savings?". This is a question that many executives ask of their teams and some ask of their own Purchasing Departments from time to time.

To be sure, sourcing activities need to go much deeper than the Iceberg Principle, or just negotiated price. Organizations that allow themselves to be fooled by ineffective sourcing activities that focus on just price alone, will be continuously disappointed by those periodic cost reduction initiatives that produce nothing of any tangible or sustainable value.

For organizations that source correctly, that consider all of the items below the water line as noted above, they will reap long term sustainable results and be able to budget costs accordingly. To validate whether those cost savings are actually happening requires an audit.

Traditional financial documents such as the P & L can rarely be used to identify or validate cost savings because of the summary nature of the document itself. With over 130 expense categories jammed into 25 or so lines on a typical P & L, the challenge of validating savings might appear daunting. This problem can be overcome with a series of post implementation audits. If those audits focus on price accuracy. use of the proper supplier, checking in on forecasted spend and consumption and if the correct items are used…. well then you have validated your cost savings and done a good job for your organization. When management asks, "Where are the Cost Savings?" you can point to your audit results as proof positive that not only are pricing and terms better, but employee behavior and decisions have improved as well, leading to sustainable cost savings today and into the future.

For more information contact:

Douglas Austin
President
StrategicSource, Inc.
Office (952) 567-7979