PROCUREMENT PRINCIPLES AND PRACTICE

PCM 102

LECTURE 4:

Benefits of Effective Procurement

Introduction

Lecture content

- How effective procurement impacts on profitability - The profit contribution effect
- Creating savings and improving efficiency
- Procurement planning, Budgeting and budget monitoring
- Achieving value for money
- The five rights of procurement

The contribution of procurement to profitability

- It’s no secret companies spend huge sums of money on procurement.
- But if organizations want to increase their profitability and bolster their bottom line (profit), they need to get their costs under control as much as they possibly can.
- The following are some ways procurement can contribute to bottom-line

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- Taking advantage of quantity discount for bulk purchases
- Through intensive research, procurement can better compare prices and take advantage of regional cost differences in similar materials.
- **Consolidate shipments.** Companies need to group supplies and materials into as few shipments as possible.
- This reduces the number of items orders are made and also take advantage of benefits for bulk purchases such as discounts and free delivery

Cont'd

- **Maintain the right inventory levels.** You don't want to have too much inventory in stock. Not only does excess inventory clutter up stores, factories, and warehouses, it also ties up working capital.
- On the other hand, you don't want to have a shortage of inventory, so customer needs can be met. In a perfect world, procurement teams would be able to maintain the precise level of inventory needed at any given time

Cont'd

- **Better negotiation skills:**
- Building good negotiation skills can win favorable trade terms for your company
- For example better negation skills could help secure constant supplies at favourable terms of payment.
- Streamlining the procurement process to reduce bottlenecks and paper works. This can be achieved through implementing electronic procurement system.

Cont'd

- Electronic procurement system helps in time savings, Cost savings, better visibility of the process etc
- Procurement can contribute to profitability by actively seeking better materials and reliable suppliers,
- Working closely with strategic suppliers to improve quality materials, and
- Involving suppliers and purchasing personnel in new product design and development efforts

Procurement planning

- The popular saying "when you fail to plan, you plan to fail"
- Procurement planning is the process of deciding what to buy, when and from what source.
- Planning for procurement helps to streamline procurement process, consolidate requirements, monitor budgets.
- Procurement planning is a key component of budgeting for an entity

Cont’d

- Procurement Planning is important because
- It helps to decide what to buy, when and from what sources
- It is an opportunity for all stakeholders involved in the processes to meet in order to discuss particular procurement requirements.
- It permits the creation of a procurement strategy for procuring each requirement that will be included in the procurement plan.

Cont’d

- Such strategy includes a surveying the market and determining the applicable procurement method (single, sole or competitive tendering) given the requirement and the circumstances.
- Procurement planning helps to avoid maverick buying
- Planners can assess feasibility of combining or dividing procurement requirements into different contract packages

Cont'd

- It allows for the monitoring of the procuring process to determine how actual performance compares with planned activities
- It helps to determine before hand the features including quality and technical requirements items to be procured must possess.

The five rights of procurement

- The five rights (or five Rs) are a traditional formula that expresses the basic objectives of procurement.
- They are also the general criteria against which procurement performance is measured.
- So they are sometimes referred to as key performance indicators (KPIs).
- In other words, areas where procurement performance is assessed.

Cont’d

- **The 'right quality'**
  Obtaining goods which are of a satisfactory quality as well as fit-for-purpose (suited to internal and external customer needs):
  - Accurate specification of requirements and quality standards
  - Supplier- and buyer-side quality management

Cont'd

- **if the right quality is not achieved**
  - Stock may have to be rejected or scrapped
  - Production machinery may be damaged
  - Finished products may be defective and, in turn, have to be scrapped or re-worked
  - Defective products may reach customers, resulting in recalls, returns, compensation claims, lost goodwill and a damaged reputation
  - The firm will incur high costs

Cont'd

- **The 'right quantity'**
  Obtaining goods in sufficient quantity to meet demand and maintain service levels while minimising excess stock holding (which incurs costs and risks):
  - Demand forecasting
  - Inventory management
  - Stock replenishment systems

Cont'd

- **If the right quantity is not achieved**
  - Insufficient stock may be held to meet demand
  - Stockouts may cause bottlenecks or shutdowns in production; costs of idle time; late delivery to customers; lost credibility, goodwill and sales
  - Excess stock may be ordered and/or held: tying up capital in idle stock; wasting storage space; risking deterioration, theft or damage; risking obsolescence or disuse; incurring 'holding costs'

Cont'd

- **The 'right place'**
  Having goods delivered to the appropriate delivery point, packaged and transported in such a way as to secure their safe arrival in good condition:
  - Distribution planning
  - Transport planning
  - Packaging

Cont'd

- **If the right place is not achieved**
  - Goods may be delivered to the wrong place, resulting in delays and correction costs
  - Goods may be subject to unnecessary transport and handling (as well as related costs)
  - Goods may be damaged, contaminated or stolen in transit
  - Transport may cause unnecessary environmental damage

Cont'd

- **The 'right time'**
  Securing the delivery of goods at the right time to meet demand, but not so early as to incur unnecessary inventory costs:
  If the right time is not achieved
  - Goods may be too late, causing production bottlenecks (and associated costs) and/or delays in delivery to customers (costs of damages, lost business)
  - Goods may be too early, causing undue risks and costs of holding inventory

Cont’d

- **The 'right price'**
  Securing all of the above at a price which is reasonable, fair, competitive and affordable. Ideally, minimising procurement costs in order to maximise profit:
  - Price analysis
  - Supplier cost analysis
  - Competitive pricing and negotiation

Cont’d

- **If the right price is not achieved**
  - Suppliers will be free to charge what they like, without checking
  - Suppliers' profit margins will be 'squeezed' unfairly, leading to insecurity of supply
  - Materials and supply costs will rise
  - Profits will fall or prices charged to customers will have to rise (resulting in a loss of sales)
  - There will be less profit to motivate shareholders and to re-invest in the business

Achieving right quality supplies

- Quality supplies is very important.
- We have just discussed that procurement planning can help us work towards quality
- Quality is, to an extent, 'in the eye of the beholder'.
- People have different perceptions about what standard of functionality, durability or presentation is 'acceptable' or makes one product 'superior' to another.
- Some people may associate quality with a premium price, or a brand label.

Eight Dimensions of Quality

- David A Garvin identifies eight generic dimensions of product quality.
  - **Performance:** the operating characteristics of the product
  - **Features:** value-adding characteristics and service elements (such as warranties and after-sales service)
  - **Reliability:** the ability of the product to perform consistently over time
  - **Durability:** the length of time a product will last (and stand up to normal usage) without deterioration or damage

Eight Dimensions of Quality cont.....

- **Conformance:** whether agreed specifications and standards are met
- **Serviceability:** the ease and availability of support services
- **Aesthetics:** how appealing or pleasing the product is to the senses of the user
- **Perceived quality:** the subjective expectations and perceptions of buyers.

- For a buyer looking to buy materials, components or other supplies in a commercial setting, the most important definitions of 'right quality' are likely to be **fitness for purpose** and **conformance to specification**.
- Note that both of these criteria are essentially focused on the supplier's ability to satisfy the needs and expectations of the customer or buyer.
- Van Weele argues that: ***'Quality is the degree in which customer requirements are met.***

Services Quality

- **Why are services different when it comes to quality definition and management?**
  - Because services are intangible, it is much more difficult to specify service requirements accurately, and to measure them, when delivered, against specifications and expectations.
  - Because services are produced by different people in unique circumstances each time, it is much more difficult to standardise the quality or consistency of service provision.
  - The exact purpose or use of physical goods will usually be known, and their fitness for purpose can therefore be assessed objectively. It is harder to assess the many factors involved in providing a service.

SERVQUAL Model

- Seeking a solution for these difficulties, Parasuraman, Ziethaml & Berry developed an approach to the measurement of service quality which they called **SERVQUAL.**
- The SERVQUAL model suggests that there are five generic dimensions on which customers or procuring entities can evaluate services (such as cleaning) when procuring them.
  - Tangibles
  - Reliability
  - Responsiveness
  - Assurance
  - Empathy

- **Tangibles** refers to physical facilities, equipment and appearance of personnel
- **Reliability** is the firm's ability to perform the promise service accurately and dependably
- **Responsiveness** is the firm's willingness to help customer and provide prompt service
- **Assurance** is knowledge and courtesy of employees and their ability to inspire trust and confidence
- **Empathy** is caring and individualized attention paid to customers

Procurement's contribution to quality

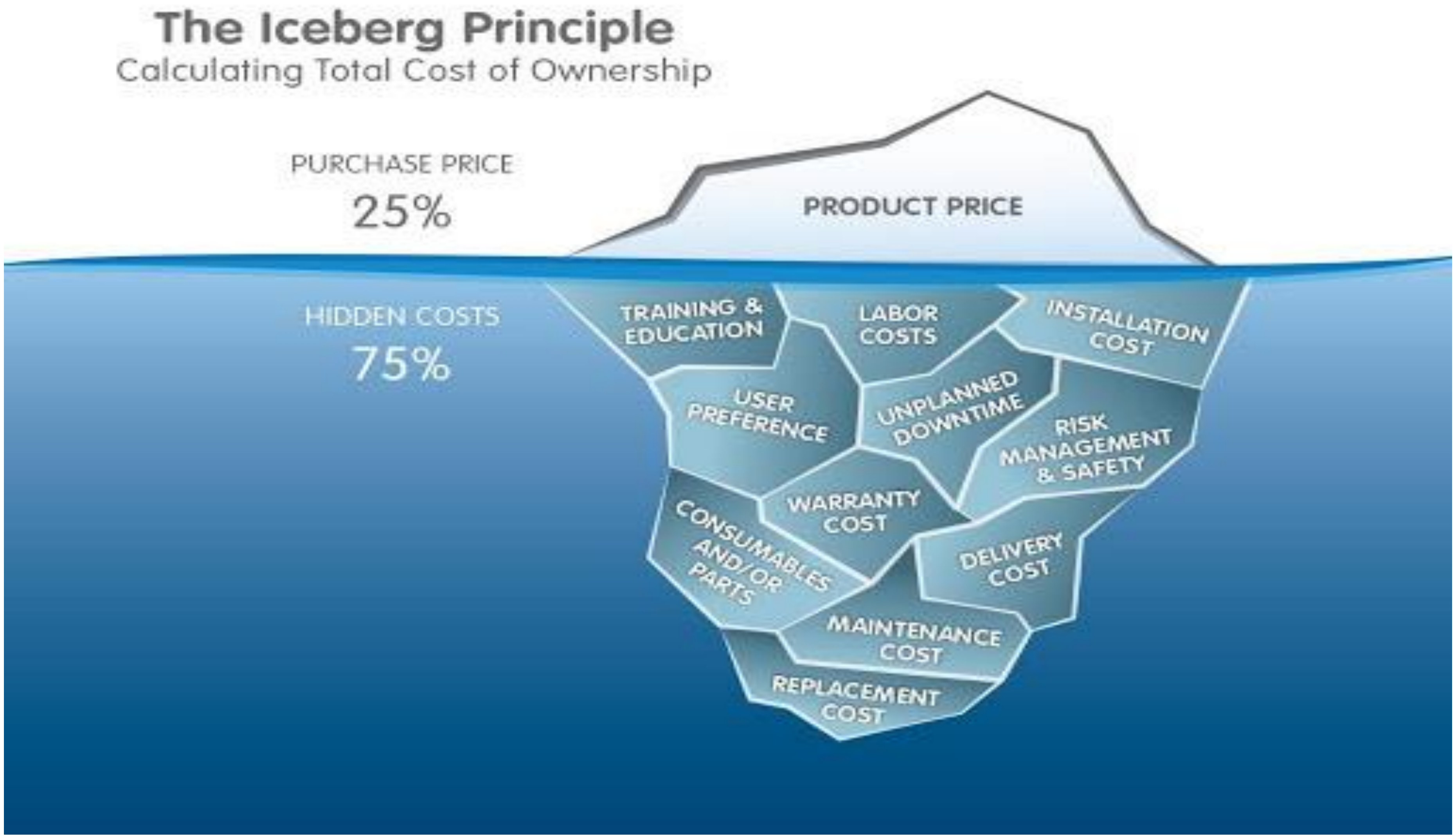
- Purchasers can thus help to provide 'the right quality' by a wide range of means.
  - Selecting suppliers with third party approved or accredited **quality management systems** (eg ISO 9000).
  - Appraising and approving suppliers' quality management systems **(supplier certification)**
  - Making it clear to all suppliers that preference in the award of future contracts will be given to suppliers able to offer reliable quality performance.
  - Preparing preferred or **approved supplier lists.**
  - Monitoring and controlling suppliers' quality performance over time .

Achieving value for money

- Value for money refers to the utility derived from every purchase or every sum of **money** spent.
- **Value for money** is based not only on the minimum purchase price but also on the maximum efficiency and effectiveness of the purchase through out its use.
- A popular model that helps to assess value for money is total cost of ownership (TCO)
- **This was discussed in lecture 1**

Total cost of ownership

- In its attempt to ensure value for money, it must consider the TCO
- Total cost of ownership (TCO) is the purchase price of an asset plus the costs of operation.
- When choosing among alternatives in a purchasing decision, buyers should look not just at an item's short-term price, which is its purchase price, but also at its long-term price, which is its *total cost of ownership*.


The Iceberg Principle
Calculating Total Cost of Ownership
PURCHASE PRICE
25%
PRODUCT PRICE
HIDDEN COSTS
75%
TRAINING & EDUCATION
LABOR COSTS
INSTALLATION COST
USER PREFERENCE
UNPLANNED DOWNTIME
RISK MANAGEMENT & SAFETY
WARRANTY COST
CONSUMABLES AND/OR PARTS
DELIVERY COST
MAINTENANCE COST
REPLACEMENT COST

Components of TCO

- Purchase price
- Maintenance cost
- Training
- Repair cos
- Cost of disposal