

White Paper

Discretionary Spend Management

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1. Explanation and Quantification:

Wiki Definition of “Discretionary Spending:

“The amount or portion of a person's or group's expenditure which is used for non essential or voluntary disbursements; the amount or portion of one's expenditures which one may make as one sees fit”.

This definition can be broadened to include spend where suitable but cheaper alternate products or services could be used with minimal to zero impact on the business.

This document provides a detailed explanation of the potential corporate savings through improved Discretionary Spend Management and how this process can be aided by implementing Purchase to Pay (P2P) Spend Control software.

The objective is to enable organisations to consider and quantify the potential savings through improved focus and controls over corporate spend, as it is far easier to save money than generate it.

Who is in control of your corporate discretionary spend?

Almost every organisation has decentralised corporate spending, placing the responsibility in the hands of the senior management / budget holders for purchasing.

The budget holders have delegated responsibility for placing purchase orders (subject to suitable approval) into the line management within their respective departments.

The line management usually delegate responsibility for the raising of purchase requests, selection of suitable suppliers and goods (and often the negotiation of any prices) to their administration staff.

These administration staff often have no formal training or corporate guidance in procurement best practice.

The result is a highly dispersed and disjointed purchasing methodology where it can be easily argued that each department acts in isolation as if it was a separate business and there is no one person who is both responsible and in control of corporate spend.

Habitual Buying Practises

The vast majority of spend continues historical habits which includes what is being bought, who it is bought from, the price paid and the payment terms.

It is understandable that staff will usually follow the established buying habits, because it is easy, it has been approved before and it is not seen as their responsibility to make changes.

It is equally true that what is spent is usually directly related to the available budget, irrespective of whether the purchase is critical to the business.

To evaluate your company's diligence of discretionary spend management; consider the following questions regarding the current levels of control in your business:

When was the last time:-

1. The business made a detailed review of the buying practices and questioned whether the existing habits were still appropriate for the business – especially in a more challenging commercial environment?
2. The business made a detailed review of suppliers and set out to consolidate similar purchasing to a single supplier to improve buying terms?
3. The business reviewed the quality and relevance of what is being purchased, whether equivalent but less costly alternatives are available and what is simply no longer required?

The answer to these questions is almost always “too long ago, if ever”, reflecting the fact that no one person has the responsibility AND the authority to undertake a detailed purchasing review of the business.

Perhaps as important, the company has no easy or effective means to implement and control any of the decisions that it might make in these areas.

Under Management Procurement

The benchmark for procurement best practice is the percentage of total spend that is actively under management.

As the title suggests, the objective is to systematically undertake a review of all areas of spend, verify the requirement and its importance, quantify the specific need and then source the most cost effective goods or services to meet that requirement. However, the most important part of this is that the process is repeated on a regular basis to ensure that corporate spend continues to be optimised. This may well involve renegotiating with existing or new suppliers and their terms of supply every six months

This is a daunting task. But quick look at the number of active suppliers (in turnover order), will highlight the starting point. For most businesses, the 70 – 30 rule applies where 70% of corporate spend is through only 30% of the suppliers, especially when similar suppliers are consolidated.

The process of bringing corporate spend under management is a journey, not a destination. The process is on-going and never stops and like all journeys, it requires taking the first step.

In most organisations, aspects of this process do exist in isolated areas of considerable spend. The IT department is usually a good example, but the methodology is often “informal” as it is not documented.

The benefits of a formal process to bring an increasing percentage of corporate spend under management is obvious. The challenge remains to determine who is responsible for this activity and the provisioning of infrastructure and automation to enable the effective implementation of the decisions made across the organisation.

2. Potential Savings

The savings available from Discretionary Spend Management fall into four major categories:

1. Deferred / cessation of purchases of non essential items and services
2. The selection of lower cost alternative goods and services
3. The successful implementation of the policies and decisions across the enterprise.
4. The availability of resource within the organisation to undertake the process

Deferred / cessation of purchases of non essential items and services

In almost all organisations, purchases are being made on a daily basis, that are not essential. The reason they are made is because they are habitual, they are within the available budget and are approved almost without thought.

It is clear that this type of expenditure is difficult to control, as it requires the co-operation and increased attention of a considerable number of people.

The challenge is how to increase the level of focus and attention that is given to this activity by the purchasers and the approvers, so that unnecessary spend is either deferred or simply rejected.

The most effective approach to increase focus on managing discretionary spend is to reduce the available budget. This approach requires the buy in and support of the board of directors, as they ultimately are responsible for the budgets.

By squeezing the amount of funds available, the organisation will start thinking about what is really essential, what is desirable and what is a “nice to have”.

The ability of the requisitioner (person that raises the request for purchase) to quantify their perception of the importance of each purchase aids this process significantly. As important, the requisitioner should have the ability to document the rationale to support their view as an additional aid to the approver.

A key component in the approval process is the available budget headroom within the given period. Both the requisitioner and the approver should have access to this information in real time (as other purchase approvals will change the information on a moment by moment basis).

The approver can then make the decision whether to accept the request, defer the request, or reject the request based on all the available information.

The size of the change to available budgets will directly impact the level of focus given.

This approach does not stop the ability to make purchases for critical items that fall outside the revised budget, but the approval process should be more difficult and more diligent.

Over budget spend should require more senior management, or, if required, board approval. The implications of having to take a request to the board will really get the desired focus of the individuals involved.

Savings

If we assume that the initial reduction of available budget is set at between 2 - 5% across all expenditure and that subsequent over budget approvals absorb 50% of the potential saving, it will still deliver a net saving of between 1% and 2.5% of total spend.

However, this does assume that the business has the ability to easily change budgets, that the requisitioner and approvers have access to that information in real time and that the formal approval processes are in place to ensure the correct escalation of all over budget requests.

The selection of lower cost alternative goods and services

The recession has clearly demonstrated the ability of the public at large to adjust their spending habits in line with their changing priorities.

The fast growing unemployment statistics have created considerable job insecurity for those who are still employed. Today almost everyone knows of individuals that have lost their jobs and the impact it is having on their life.

The result has been a significant increase in personal savings (40%) reflecting a reduction in discretionary spend, combined with a fundamental change in how daily spend is managed. The revenue growth of low cost suppliers (such as Lidl) and the rapid change in product price profile offered (M&S) are clear demonstrations that the public is exercising discretionary spend management for their personal income.

They are either deferring spend or selecting alternative and lower cost products which have very little impact on the welfare of the individual. These are the same individuals that we all employ.

The opportunity to leverage this new awareness of the importance of discretionary spend management (to the mutual benefit of all employees and employers) has never been more relevant or more feasible to implement.

Most organisations have "standardised" on many of the regular expenditure items across the organisation. These buying habits have been in place for many years and just happen because they have never been questioned.

Example:

A very simple real world example is the use of Royal Mail. The total cost of postage for many organisations is significant, reflecting the cost of posting a letter, plus the contents and envelope and the labour to create it:

An organisation diligently generates 40,000 purchase orders per annum and posted them to the supplier. The purchase orders are generated manually on a physical A4 multipart set, put into a standard high quality A4 envelope and sent first class post. This practice had never been questioned.

- Each order was costing 61p in postage, rather than 39p for a letter envelope.
- The quality of envelope used cost 5.25p, when a cheaper alternative was available at fractionally under 1p.
- The total cost of just posting out orders was 66.25p each, or £26,500 per annum.
- Using a standard letter envelope reduced this annual cost to £16,000.
- Saving £10,500 per annum.

The final solution was to automate the purchase to pay process and send every order electronically and saved the full £26,500 whilst removing the risk and delay of Royal Mail.

This small example of habitual methodologies demonstrates the potential of reviewing how corporate cash is currently being spent and looking at practical and cheaper alternatives.

Savings

As soon as you start to consider the depth and breadth of habitual purchasing practises, it is clear that there is an opportunity to make significant savings with little to no impact on the performance of the business.

The purchasing of suitable cheaper alternatives can deliver tens of thousands of pounds of repeatable savings every year.

A simple method of estimating the savings is a percentage of total spend. Most organisations base their estimate on between 1% and 5%, reflecting their review of the level of habitual spending, the level of focus that has been placed on this activity in the past few years and their confidence of the savings opportunity.

The successful implementation of the policies and decisions across the enterprise

The commercial arguments for implementing discretionary spend management are very compelling and it is clear that a relatively small amount of time is required to start identifying business activities where savings can be quickly achieved.

The hard part is transforming the opportunity into standard working practices undertaken by all the relevant staff across the organisation. It is one thing to send out an email saying that a particular supplier or a selected range of products should be used by all from this day forth, it is quite another

to get that decision adopted by all, every time. The likelihood is that after a short period most will revert to their earlier habitual process.

The most effective way to change the buying practices of an organisation is to remove the ability of any individual to deviate from the policy unless it is under exceptional circumstance and then police and control those exceptions.

If the method of purchasing is manual using a hand written purchase order multipart set, it is clear that the control will remain in the hands of each purchaser and be very labour intensive to audit.

Whether a saving is generated from a consolidation of suppliers, or selection of preferred alternate products and service, the ability to easily deploy and enforce a corporate wide purchasing policy is the foundation stone for discretionary spend management.

The obvious answer is to automate the purchasing process and deliver the ability to enforce the suppliers available for given products and services, the range of products and services available and automate the agreed prices across the organisation.

If the purchaser does not have a choice, then they will follow corporate policy with 100% accuracy and complete the ordering task in a far shorter time.

Any future change in the selection of suppliers, products, service and prices can be implemented in moments across the enterprise.

This approach does not require communication, education or explanation. It is centrally controlled and fully automated throughout the business, then followed on every occasion.

The availability of resource within the organisation to undertake the process

So who is going to take on the responsibility of implementation and managing discretionary spend management?

Most small and medium sized organisations do not have a central procurement department or a formal corporate buyer role. The existing staff are all too busy with their day jobs to take on such a wide ranging role and do not have the necessary authority (or skills) to dictate to other departments.

There are two distinct approaches to this challenge:

1. Significantly improve the productivity within the organisation to make the time available for each department to improve their focus on managing discretionary spend
2. Create a centralised procurement / buyer role which has the responsibility to help every department maximise the effectiveness of their available budget.

(This document does not discuss the productivity gains from automation of the purchase to pay process in detail and we recommend that you review the Compleat "Return on Investment" white paper for this information. (www.compleatsoftware.com/whitepaper))

It is truly extraordinary that the methodology used to spend the hard earned corporate cash has changed little in 30 years. It is probably the only area of the business where there remains the day to day use of “multipart hand written sets” for order creation, internal post for hard copies of orders and invoices for approval to be circulated and little if any data capture until an approved purchase invoice is finally posted to the accounts – which is the first time the company becomes aware of the cash liability it committed to weeks if not months before.

The productivity gains available from purchasing automation are immense, as are the commercial advantages of full commitment accounting on order creation, fully automated and centralised budget control, electronic invoice approvals and automated electronic workflows to enforce the correct approval process. Every finance director will understand the value of real time accurate management information, budget availability and cashflow forecasting.

The productivity gains made by the purchase order requisitioner and approver, the purchase invoice approver and the finance department provide the headroom to start the process of implementing discretionary spend management.

Whether an organisation leverages this resource or alternatively decides to redeploy resources to a formal purchasing role is a decision each company can make as appropriate.

3. Conclusion

It is inconceivable that another 10 years will pass before every organisation has implemented a fully automated purchase to pay solution and taken control of corporate spend. Whilst early adopters will have a competitive advantage in reduced costs, a far more effective process and superior management information, over time it will become a competitive necessity.

The value of discretionary spend management is not in question.

The turning point in market adoption is when a commercial affordable solution becomes available and how long it takes a finance director to discover it.