



Purchasing & Supply Chain  
**Management**

6<sup>TH</sup> EDITION

MONCZKA • HANDFIELD • GIUNIPERO • PATTERSON



# Purchasing and Supply Chain Management

SIXTH EDITION

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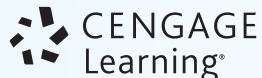
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*To Shirley, Kathleen, Thomas, and Elliana*

*ROBERT M. MONCZKA*

*To Sandi, Simone, and Luc, and the memory of my brother Carlo*

*ROBERT B. HANDFIELD*

*To Maryetta, Tressa, Jan, Matthew, Michael, and Amanda*

*LARRY C. GIUNIPERO*

*To Diane, Lindsay, Karl, Drew, Laura, Seth, Luke, and Norah*

*JAMES L. PATTERSON*



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# Preface

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The Sixth Edition of *Purchasing and Supply Chain Management* reflects the ever-changing face of supply management and the increased recognition in boardrooms of organizations across every industry. The challenges experienced by organizations are calling for a new type of supply manager with many different capabilities. Students seeking to pursue a career in supply management may choose to focus on one or more of these areas as they consider where in supply management they wish to focus.

- **Internal Consultant**—Ability to connect, listen, and deliver business value to internal stakeholders. Building a strong P2P system to drive improved procurement transaction excellence and driving results that matter to the business.
- **Market Intelligence & Cost Modeling Analytics**—Deployment of total cost analytic modeling and cost to serve capabilities, application of analytical cost modeling approaches for decision support, and building supply market intelligence data gathering and knowledge dissemination capabilities. Deep knowledge and understanding of macro economic forces and ability to relate them to future market movements and forecasts.
- **Financial Acumen**—Knowledge of currency, capital markets, and contribution of procurement to P&L and balance sheet. Ability to contribute to CFO and other financial leadership discussions and debates. Ability to build logistics cost models, understand contribution of supply management to capitalization, facility productivity, and other key metrics.
- **Risk Mitigation**—Knowledge of different sources of risk, ability to build risk profiles, link recognition of risks to risk mitigation and scenario planning, and understanding how to manage disasters when they occur. Building a business case for risk mitigation planning.
- **Supplier Coach**—Ability to deploy supplier development to drive improvement in high-need categories or regions, especially in emerging countries where local content is required. Becoming a customer of choice and driving improvement in supplier capabilities. Harnessing supplier innovation and developing solutions to stakeholder requirements.
- **Relationship Broker**—Managing teams in multicultural environments, managing virtual teams, and understanding pros and cons of different organizational models (centralization vs. decentralization). Working with global engineering teams and understanding of technical knowledge. Managing outsourced relationships and services. Driving supplier innovation and linking to internal teams.
- **Legal Expertise**—Building relational contracts, understanding legal contractual language, terms and conditions, legal clauses, and vernacular. Building good price and cost modeling indices for contracting, and managing risks and rewards through improved contract structure. Best practices in on-going contract management. Managing conflicts that emerge post-contract signing. Dealing with IP issues when working with suppliers.
- **Talent Management**—Building a pipeline of leadership and supply management expertise, mentoring, and leadership development.

The Sixth Edition emphasizes these competencies through new material and emphasis on traditional competencies that have become more important recently. This new edition



includes a number of new topics, including cases in health care, oil and gas, and financial services, industries that have downplayed the role of strategic supply management in the past.

In addition, some of the subjects that are newly introduced or expanded upon in this edition include:

- Cross-functional teaming
- Procurement analytics
- Application of mobile technologies in the supply chain
- Supplier integration into new product development
- Software as a service applications for procurement
- Social networking and cloud applications
- The role of “big data” in procurement
- Supplier development
- Cost modeling and market intelligence
- The role of procurement logistics in globalization
- “Should cost” modeling
- Supplier collaboration for cost savings ideas
- Negotiation simulations
- Contracting and Internet law
- Supply chain risk management
- Sustainability in the supply chain
- The importance of labor and human rights in procurement contracts and codes of conduct
- The role of transportation infrastructure and government regulation in global logistics
- Public procurement and acquisition
- Crowd-sourcing and open innovation
- Impact of sourcing strategies on revenue, capital asset management, and share price of the enterprise
- Deployment of category management
- Expanded and comprehensive cases, sourcing snapshots, and good practice examples pulled from direct interviews with senior procurement executives

We are proud of this new edition and believe that it reflects many themes that are only beginning to emerge in industries worldwide.

## Course Description

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*Purchasing and Supply Chain Management* is intended for college and university courses that are variously titled purchasing, materials management, supply chain management, sourcing management, supply management, and other similar titles. The text is also well suited for training seminars for buyers, and portions of it have been used in executive education forums. Chapters have been used in both undergraduate and M.B.A. classes in supply management, business strategy, operations management, and logistics. Some instructors may also elect to apply sections of the book to undergraduate or graduate classes in operations management.

The text is appropriate for either an elective or a required course that fulfills AACSB International: The Association to Advance Collegiate Schools of Business requirements for coverage of supply chain management issues. Most of the cases included in the book are based on actual companies and all were adapted and modified through classroom use by the authors.

## Course Objectives

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Depending on the placement of a course in the curriculum or the individual instructor's philosophy, this book can be utilized to satisfy a variety of objectives:

1. Students should be made aware of the demands placed on purchasing and supply chain managers by business stakeholders, both internally and externally to the firm.
2. As prospective managers, students need to understand the impact of purchasing and supply chain management on the competitive success and profitability of modern organizations.
3. Students should appreciate the ethical, contractual, risk management, sustainability, and legal issues faced by purchasing and supply chain professionals.
4. Students must understand the increasingly strategic nature of purchasing, especially the fact that it involves much more than simply buying goods and services.
5. Students entering or currently in the workforce must understand the influence of purchasing on other major functional activities, including product design, information system design, e-commerce, manufacturing planning and control, inventory management, human resource development, financial planning, forecasting, sales, quality management, and many other areas.

## Unique to This Edition

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Many of the insights and topics presented throughout this book are based on examples developed through discussions with top purchasing executives and from various research initiatives, including research published by CAPS Research, work at the North Carolina State University Supply Chain Resource Consortium, and a project on supplier integration funded by the National Science Foundation. The text also has a chapter format that includes an opening vignette, a set of sourcing snapshots, and a concluding good practice example that illustrates and integrates each chapter's topics. New and updated vignettes and examples, discussion questions, and additional readings provide up-to-date illustrations of the concepts presented in each chapter. In addition, as mentioned earlier, a number of new or enhanced topics are included.

The concept of cross-functional teaming and collaboration is emphasized throughout this book. Therefore, many of the case exercises require a team effort on the part of students. We recommend that the instructor have students work in teams for such projects to prepare them for the team environment found in most organizations.

## Structure of the Book

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This book is subdivided into six parts and twenty chapters that provide thorough coverage of purchasing and supply chain management.

## Part 1: Introduction

Chapter 1 introduces the reader to purchasing and supply chain management. This chapter defines procurement and sourcing, introduces the notion of the supply chain, and summarizes the evolution of purchasing and supply chain management as an organizational activity.

## Part 2: Purchasing Operations and Structure

The chapters in Part 2 provide an in-depth understanding of the fundamentals surrounding the operational activity called supply management. These chapters focus primarily on the fundamentals of purchasing as a functional activity. Without a solid understanding of purchasing basics, appreciating the important role that purchasing can play is difficult.

Chapter 2 provides an overview of the purchasing process by presenting the objectives of world-class purchasing organizations, the responsibilities of professional purchasers, the purchasing cycle, and various types of purchasing documents and types of purchases. In addition, this chapter now includes health care and services supply management case examples and snapshots. The Procure-to-Pay (P2P) cycle has been updated with new research in the process.

Chapter 3 examines various categories and types of purchasing policy and procedure. Ethical issues in procurement are emphasized here. This chapter includes updates on corporate social responsibility and sustainability as a component of purchasing policy and procedures as well as an updated list on the best companies for social responsibility and diversity in procurement.

Chapter 4 examines purchasing as a boundary-spanning function. Much of what purchasing involves requires interacting and working with other functional areas and suppliers. This chapter examines the intra-firm linkages between purchasing and other groups, including suppliers.

Chapter 5 focuses on purchasing and supply chain organization. This includes a discussion of purchasing in the organizational hierarchy, how the purchasing function is organized, and the placement of purchasing authority, including the center-led approach. The chapter also describes the team approach as part of the organizational structure.

## Part 3: Strategic Sourcing

A major premise underlying this book is that purchasing is a critical process and makes as important a contribution as manufacturing, marketing, or engineering to the pursuit of a firm's strategic objectives. Progressive firms have little doubt about purchasing's impact on total quality, cost, delivery, technology, and responsiveness to the needs of external customers. Part 3 addresses what firms must do to achieve a competitive advantage from their procurement and sourcing processes. Realizing these advantages requires shifting our view of purchasing from a tactical or clerically oriented activity to one focusing on strategic supply management. This type of management involves developing the strategies, approaches, and methods for realizing a competitive advantage and improvement from the procurement and sourcing process, particularly through direct involvement and interaction with suppliers.

Chapter 6 develops an understanding of how firms set purchasing strategies and category management. This process should include a vision and plan of what a firm must do in its purchasing/sourcing efforts to support the achievement of corporate goals and

objectives. Clearly, the category strategy development process should be the starting point for any discussion of strategic supply management. This chapter contains an updated section on strategic category management, reflecting the latest developments in the field. There are also discussions of insourcing versus outsourcing as a component of strategy, with examples featuring Boeing Corporation, illustrating how the economic recession is impacting category management strategies. There is also a new section on how to perform market intelligence and risk assessments for category management, as well as fresh information on stakeholder engagement.

Chapter 7 focuses on one of the most important processes performed by firms today—supplier evaluation, selection, and measurement. Selecting the right suppliers helps ensure that buyers receive the right inputs to satisfy their quality, cost, delivery, and technology requirements. Choosing the right suppliers also requires doing due diligence via supplier visits. Performing the selection process correctly creates the foundation for working closely with suppliers while continually enhancing performance.

Chapter 8 describes how a progressive and proactive buying firm incorporates supplier quality into its supplier selection and supplier performance evaluation processes. Improving supplier quality can also create substantial tactical and strategic competitive advantages that may not be available to competing firms. Six Sigma, ISO 9000, and ISO 14000 applications have been updated, and there are new sections on The Seven Wastes (Honda's BP process) and Basic Contents of a Supplier Quality Manual.

Chapter 9 describes what firms must do to manage and develop world-class supply-base performance. A focus on supplier development, managing supply base risk, and sustainability in the supply chain is provided. New sections to this chapter include Managing Supply Base Risk and Managing Sustainability in the Supply Base.

Finally, Chapter 10 focuses on worldwide sourcing, which is an important part of strategic supply management as firms search globally for the best resources.

## Part 4: Strategic Sourcing Process

Chapter 11 focuses on strategic cost management, cost/price analysis, and target costing. Progressive firms focus on cost control and reduction with suppliers as a way to improve (i.e., reduce) purchase price over time. This chapter details various types of costs, presents cost analysis techniques, and discusses the factors that affect a supplier's price. The chapter also discusses total cost analysis, cost-based pricing, use of pricing indicators for category management and other innovative techniques designed to provide accurate and timely cost data. New sections on both strategic cost management and target costing at Honda of America and pricing indicators for different categories are included, as well as best practice research on strategic cost management based on a 2009 study.

Purchasing professionals rely on an assortment of tools, techniques, and approaches for managing the procurement and supply chain process.

Chapter 12 presents various quantitative tools that purchasers use when problem solving and pursuing performance improvements. Process mapping, value analysis, price break analysis, and the learning curve can help purchasers achieve specific outcomes such as reducing cost/price, improving quality, reducing time, or improving delivery performance from suppliers.

Chapter 13 deals with supply management negotiation. Effective supply managers must know how to plan for and negotiate value-adding contracts within a buyer-seller relationship. Increasingly, procurement contracts emphasize far more issues than simply

purchase price. Buyers and sellers may negotiate cost reductions, delivery requirements, higher quality levels, payment terms, access to technology, or anything else important to the parties. The Negotiation Framework in Supply Management section has been revised, and The Impact of Electronic Media on Negotiations has been updated and expanded.

Chapter 14 addresses the fundamentals of contracting. The formal contracting process creates the framework for conducting business between two or more firms. As such, an understanding of contracting is essential when attempting to manage costs within a buyer-seller relationship. Contract management best practices are viewed in light of recent events and supply chain risk.

Chapter 15 addresses the major legal considerations in purchasing, including the legal authority of the purchasing manager. The chapter also discusses sources of U.S. law, warranties, purchase order contracts, breaches of contract, and patent and intellectual property rights. Because contracting is a part of the legal process, this chapter naturally follows the contracting chapter.

## Part 5: Critical Supply Chain Elements

Part 5 describes the major activities that relate to or directly support supply chain management. Some of these activities involve specific disciplines, such as inventory management or transportation; other activities relate to the development of supply chain support systems. These systems include performance measurement systems and computerized information technology systems. The activities presented in this part may or may not be a formal part of the purchasing organization. These activities and systems, however, are key elements of purchasing and supply chain management.

Without them, purchasing most likely cannot pursue its goals and objectives effectively. Therefore, purchasing students must be familiar with a range of supply chain activities.

Chapter 16 focuses on overall lean thinking in supply management, including the management of a firm's inventory investment. The money that a firm commits to inventory usually involves a significant commitment of financial resources. This chapter discusses the function of inventory within a firm, factors leading to inventory waste, creating a lean supply chain, approaches for managing a firm's inventory investment, and future trends related to managing inventory.

The purchase of transportation and other services is another important supply consideration. We have witnessed major changes in transportation over the last two decades or so, many of which have affected supply management. Since Congress deregulated the U.S. transportation industry in the early 1980s, the role of the buyer has changed dramatically. More than ever, supply management is involving itself in the evaluation, selection, and management of transportation modes and carriers. Even if a buyer does not get involved directly with transportation, having a working knowledge of this dynamic area is critical.

Chapter 17 highlights supply management's role in procuring transportation, as well as services buying, presents a decision-making framework for developing a transportation procurement strategy, discusses ways to control and influence inbound transportation, and evaluates trends affecting the purchase of transportation services, such as performance-based logistics. Four sections in this chapter have been revised or updated.

Information technology systems are changing business. Purchasing, too, can benefit from the development of current information technology systems.

Chapter 18 examines the role of technology in supply chain information systems and electronic commerce. The chapter addresses the newer Internet-based electronic linkages

between firms as well as traditional electronic data interchange (EDI). The chapter also discusses the impact of social networking, blogs, and cloud computing in addition to advanced and future e-purchasing and supply systems' applications. The use of information technology systems greatly enhances supply management's ability to operate at the highest levels of efficiency and effectiveness.

Chapter 19 focuses on performance measurement and evaluation with a new emphasis on innovation sourcing and an update on trends. Increasingly, firms must develop valid measurement systems that reveal how well a firm is performing, including the performance of its purchasing and supply chain management efforts. These systems need to be clearly linked to overall company objectives. Measurement systems support procurement and sourcing decision making by providing accurate and timely performance data. This chapter examines why firms measure performance, defines various purchasing performance measurement categories, and discusses how to develop a purchasing performance measurement system, including a balanced scorecard. In this chapter, data on supply strategy performance results has been updated.

## Part 6: Future Directions

Chapter 20 focuses on what purchasing and supply chain management will look like by 2018. These trends, which are adapted directly from recent surveys and studies of key executive managers from a variety of global organizations, can help students identify how the field of purchasing and sourcing management is changing and what skills they will need to develop in view of these changes. The latest predictions are included from CAPS Research Executive Assessments of Supply, a joint CAPS Research, A.T. Kearney, and ISM study focused on supply strategies for the decade ahead, and other research studies and discussions with supply executives.

## Case Studies and Instructor's Resources

*Purchasing and Supply Chain Management* features new and revised cases throughout the book. These cases were thoroughly tested in the classroom and used within the industry. A test bank, PowerPoint® presentations, and other ancillary instructional materials are available on the book's companion website to help instructors identify how best to use and interpret the text and cases. Of particular interest are the negotiation and supplier selection cases, which allow students to experience personally the purchasing decision-making process in real time. Access the companion website by going to [www.cengagebrain.com](http://www.cengagebrain.com) and searching for this book by its title.

# Acknowledgments

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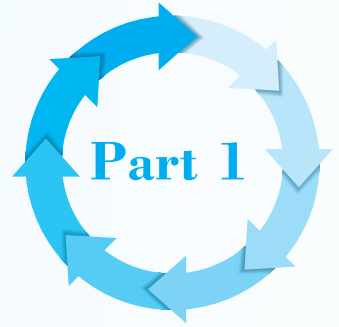
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# Introduction

## Chapter 1 Introduction to Purchasing and Supply Chain Management





# Introduction to Purchasing and Supply Chain Management

## CHAPTER 1

### Learning Objectives

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#### After completing this chapter, you should be able to

- Understand the differences between purchasing and supply management
- Understand the differences between supply chains and value chains
- Identify the activities that are part of supply chain management
- Appreciate the importance of supply chain enablers
- Identify the historical stages of purchasing's evolution

### Chapter Outline

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Introduction

A New Competitive Environment

Why Purchasing Is Important

Increasing Value and Savings

Building Relationships and Driving Innovation

Improving Quality and Reputation

Reducing Time to Market

Managing Supplier Risk

Generating Economic Impact

Contributing to Competitive Advantage

Understanding the Language of Purchasing and Supply Chain Management

Purchasing and Supply Management

Supply Chains and Value Chains

Supply Chains Illustrated

Achieving Purchasing and Supply Chain Benefits

The Supply Chain Umbrella-Management Activities

Purchasing

Inbound Transportation

Quality Control

Demand and Supply Planning

Receiving, Materials Handling, and Storage

Materials or Inventory Control

Order Processing

Production Planning, Scheduling, and Control

Shipping/Warehousing/Distribution

Outbound Transportation

Customer Service

Four Enablers of Purchasing and Supply Chain Management

Capable Human Resources

Proper Organizational Design

Real-Time Collaborative Technology Capabilities

Right Measures and Measurement Systems

The Evolution of Purchasing and Supply Chain Management

Period 1: The Early Years (1850–1900)

Period 2: Growth of Purchasing Fundamentals (1900–1939)

Period 3: The War Years (1940–1946)  
 Period 4: The Quiet Years (1947–Mid-1960s)  
 Period 5: Materials Management Comes of Age  
 (Mid-1960s–Late 1970s)  
 Period 6: The Global Era (Late 1970s–1999)  
 Period 7: Integrated Supply Chain Management  
 (The Twenty-First Century)

Good Practice Example: Taking an Entrepreneurial  
 Approach to Purchasing at Babson College

Key Terms

Discussion Questions

Additional Readings

Endnotes

Looking Ahead

## *CSX Purchasing and Supply: Managing into the Winds of Change*

Michael O'Malley, a University of Illinois graduate, knows all about the winds of change from his days in his hometown of Chicago (aka the Windy City). When O'Malley was named vice president of Procurement & Supply Chain Management at CSX Transportation several months ago, he felt that changes were needed to get his sourcing team on a faster track. Since his appointment to the job, he has put the company's procurement and supply chain function on the "strategic and global" track to twenty-first century excellence.

CSX is one of four Class 1 Railroads in the United States. In 2013 the company had sales of over \$12 billion and net earnings of \$1.86 billion (\$1.83/share). With a barrel of crude oil fluctuating in the \$70 to \$125 range the past three years and fuel prices in the \$2.50 to \$3.00 a gallon range, railroads have become a favorite of many shippers interested in taking advantage of their superior fuel efficiency. The U.S. railroads' low cost-per-ton-mile allows them to compete very favorably with other transportation modes. Railroads own both the land and the rails that support the movement of freight via locomotives and railcars. Keeping a modern railroad running, however, requires that significant amounts of money be reinvested into infrastructure. The firm plans to spend approximately \$ 5 billion during 2014, which requires a skilled procurement and supply chain group to manage that spend effectively.

Supporting this favorable business growth trend and sustaining high levels of customer service, while controlling materials costs, posed major challenges for the CSX procurement and supply chain department. Meeting the challenge was compounded by a changing supply base. O'Malley states, "A reduction in the number of railroads and the subsequent consolidation of purchases resulted in a downsizing of our domestic supply base." With the growth in shipments experienced by the U.S. Class 1 Railroads, the limited number of domestic suppliers is a concern.

O'Malley and his buying team's \$5 billion annual purchase expenditures are spread over a broad group of products and services. The CSX procurement and supply chain management group purchase over 100,000 unique items necessary to keep 21,000 route miles of track, about 100,000 freight cars, and over 4,300 locomotives moving freight to customers. The geographic range is large, consisting of 23 eastern states and the District of Columbia, as well as two Canadian provinces. CSX serves thousands of localities and customers and connects to more than 70 ocean, river and lake ports. CSX's intermodal business links customers to railroads via trucks and terminals. CSXT also serves thousands of production and distribution facilities through track connections to approximately 240 short-line and regional railroads. This extensive network reaches nearly two-thirds of the population in the United States.

“Based on the demands of our operating environment, the shrinking supply base, and the need to continuously add value to the company from a supply perspective, it was a no-brainer that we had to develop a more global perspective,” says O’Malley.

His goal was to raise the skill levels of his organization to meet the global as well as other challenges required of a twenty-first century supply function. Toward that end, O’Malley requires all current employees and new hires to further develop their skill sets and attain the status of Certified Professional in Supply Management (CPSM). Currently over 70 percent of his supply management professionals are CPSM certified. “As we move to an even more strategic focus, CSX must continue to raise the bar and focus its resources on development of its highly talented professionals. The CPSM provides a basic foundation for this growth, and we are leveraging that base to develop our strategic approach to sourcing,” says O’Malley.

“The journey from a domestic to a global supply base, coupled with a more strategic focus in our supply group, allows our team to make a significant and lasting impact,” O’Malley states. Michael reorganized his resources and formed a team focused on developing current suppliers and growing the supply base. The mission of the new team is to identify commodities with sourcing sensitivities, and then develop new or existing suppliers to meet the needs of the company from a global perspective.

An early success was the development of a new steel rail supplier from Eastern Europe. With this addition, CSX now sources its steel rail from two domestic rail mills, a Japanese mill, and a recently approved mill in the Czech Republic. Assistant Vice President-Engineering Thomas Holmes led the team that identified this new opportunity, noting that “CSX has worked hard to ensure we have a strong base of suppliers, both global and domestic, who are prepared to meet all our rail infrastructure needs.”

On the locomotive side of the business, O’Malley has his Assistant Vice President-Mechanical Frank Carbone scouring the globe for wheels, brake shoes, and freight car parts. “Many of the commodities in the marketplace where we play are becoming global,” states Carbone. So, in another effort to enhance the skill set of his purchasing team, CSX had its key managers and staff attend a series of global sourcing workshops. “The customized workshops provided our team with a much deeper understanding of global sourcing issues and required relationships,” he states. To date, the department has several global sourcing initiatives in the pipeline. Some are pending approval from standards agencies like the American Association of Railroads (AAR), while others require physical, metallurgical or service testing to ensure their integrity.

“We won’t cut corners,” says O’Malley. To support that statement, the company combined resources from around CSX to centralize and expand supplier quality and product performance efforts into his group. With the cooperation and support of the Mechanical (freight cars and locomotives) and Engineering (track and structures) departments, the group was centralized in Procurement and Supply Chain Management and its scope was expanded to include all critical materials for these key internal customers.

Complementing the global push is CSX’s extensive involvement in e-commerce. The railroads have a long history of doing business electronically, beginning with their pioneering efforts in using EDI with their customers. CSX continues the use of electronic tools to facilitate sourcing. According to Neil Versteeg, Director of Process Improvement, “98.6 percent of our purchasing expenditures are now transmitted electronically. Versteeg further states, “On an average month we run about 2,000 items a day over our Oracle system.”

Putting the right structure in place to achieve results in all these different, yet related areas is no easy task. “I felt my core team was somewhat disjointed and hindered the ability to make rapid decisions,” states O’Malley. “I needed to streamline our organization and become able to identify and seize market opportunities quickly.” O’Malley’s vision is to have a lean, responsive supply management organization

that anticipates and meets the needs of CSX. “I want to be like a Home Depot... by having a quality product available, at a convenient place and at the right cost, while working with both our suppliers and internal customers to provide a very high level of cooperation and customer service after the sale.”

O'Malley is pushing his procurement team to work at a more strategic level, providing services to their business partners that add value and support the company's growth objectives. “In today's rapidly changing environment we need skilled, open-minded supply professionals who can deliver results to our organization regardless of economic conditions and in any area of spend.” I view our purchasing and supply area as a major contributor to the bottom line and critical to the service capabilities of our railroad company.” Accomplishing their mission requires a staff of dedicated professionals who can ensure availability of the locomotives, cars, track, and maintenance parts needed to keep CSX trains running at a very demanding operating capacity. O'Malley is optimistic that their sourcing group will continue to build on their string of recent successes. The winds of business change are strong, but at CSX Purchasing and Materials O'Malley feels his staff has the skills and talent to successfully navigate those changing winds.

*Source:* L. Giunipero, Interview with E. Michael O'Malley and CSX supply management personnel, June & September 2013.

## Introduction

As the CSX story illustrates, the development of strategic purchasing practices can help a company maintain or improve its competitive position in a rapidly changing business environment. In reality, it is only recently that managers would even place the words “strategic” and “purchasing” in the same sentence. Prior to the twenty-first century, the life of many purchasing professionals was comfortable and predictable. When someone required something, a buyer sent a request to suppliers for competitive bids, awarded short-term contracts based on price, enjoyed a free lunch or ball game with salespeople, and figured out how to meet not-too-demanding performance measures. Although the buying position did not carry much prestige, it was a stable job.

This model worked relatively well until new competitors from around the world showed there was a better way to manage purchasing and the supply base. New and better methods helped these competitors achieve dramatic reductions in cost, exponential improvements in quality, and unheard-of reductions in the time it takes to develop new products. This new model featured closer relationships with important suppliers, performing due diligence on suppliers before awarding long-term contracts, conducting worldwide Internet searches for the best sources of supply, and inviting key suppliers to participate in product and process development. Furthermore, executive managers began to require purchasing professionals to achieve demanding performance improvements. What really changed the purchasers' comfortable world, and ended the era of free lunches, was global competition. Borrowing a phrase from Thomas Friedman, the world is flat, and competition is now 24/7, anywhere and anytime.<sup>1</sup>

As is illustrated in the CSX story, global sourcing is a requirement and no longer a luxury for most firms. This chapter introduces the reader to the changing world of purchasing and supply chain management. The world has dramatically changed during the first 14 years of the twenty-first century, and the rate of change will continue to accelerate going forward. The first section of this chapter describes the new competitive environment where we now operate—an environment that affects every major industry. We next present the reasons why purchasing has taken on increased importance. Third, we clarify the confusing

terminology that surrounds purchasing and supply chain management. The next sections present the activities that are part of supply chain management, discuss the four enablers of purchasing and supply chain excellence, and review the historic evolution of purchasing and supply chain management. The last section outlines the contents of this book.

## A New Competitive Environment

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Today's business climate features increasing numbers of world-class competitors, domestically and internationally, that are forcing organizations to improve their internal processes to stay competitive. Sophisticated customers, both industrial and consumer, no longer talk about price increases—they demand price reductions! Information that is available over the Internet will continue to alter the balance of power between buyers and sellers. An abundance of competitors and choices have conditioned customers to want higher quality, faster delivery, and products and services tailored to their individual needs at a lower total cost. The widespread use of “social media” through Twitter and blogs spread information about products and services at an accelerated rate. If a company is not meeting its requirements, consumers will quickly “spread the word” and they will find someone who is more accommodating.

In the work environment, mobile devices permit constant contact with job activities enabling purchasers to be connected on a 24/7 basis. One of the major facilitators of increased mobility is the dramatic drop in cost of storing and retrieving data. Part of this efficiency is driven by “cloud-based” storage systems that provide all sized firms and individuals access to massive amounts of data at very low costs. The lines between work, play, buying, and promotion are both blurred and shifting to the individual. These trends in mobility have significant impact on where and when work is performed in purchasing.

While historically, the speed at which information moved was slower than current times, firms still valued customer loyalty. In the 1960s and 1970s, companies began to develop detailed market strategies that focused on creating and capturing this loyalty. Before long, organizations also realized that this required a strong engineering, design, and manufacturing function to support these market requirements. Design engineers had to translate customer requirements into product and service specifications, which then had to be produced at a high level of quality at a reasonable cost. As the demand for new products increased throughout the 1980s, organizations had to become flexible and responsive to modify existing products, services, and processes, or to develop new ones to meet ever-changing customer needs.

As organizational capabilities improved further in the 1990s, managers began to realize that material and service inputs from suppliers had a major impact on their ability to meet customer needs. This led to an increased focus on the supply base and the responsibilities of purchasing. Managers also realized that producing a quality product was not enough. Getting the right products and services to customers at the right time, cost, and place, and in the right condition, and quantity constituted an entirely new type of challenge. The twenty-first century has spawned a whole set of time-reducing information technologies and logistics networks aimed at meeting these new challenges.

The availability of low-cost alternatives has led to unprecedented shifts toward outsourcing and offshoring. The impact of China as a major world competitor poses tremendous challenges for U.S. firms in both the manufacturing and services sectors. Because the services sector now accounts for over 70 percent of the Gross Domestic Product, new strategies are required for effective supply management in this sector. Recent economic trends in Chinese wages, complexity of supply chains, and well publicized quality problems have caused firms



to reassess the economics of Chinese sourcing strategies. Chinese labor rates increased 14 percent in 2012 and are up 71 percent since 2008.<sup>2</sup> Supply strategies must now evaluate the economics of *re-shoring* and *near-shoring*. **Re-shoring** involves bringing some sourcing back to the United States, while **near-shoring** involves evaluating suppliers located closer to United States. Such suppliers may be located in Mexico and Central and South America.

All these changes have made twenty-first century organizations realize how important it is to actively manage their *supply base*. The supply base consists of all the suppliers that provide and organization with its materials and services. In some organization's this supply base extends to the network of downstream firms responsible for delivery and aftermarket service of the product to the end customer. The realization that competitive advantage could be achieved by managing both upstream (suppliers) and downstream (customers) flows led to a focus on *supply chains* and *supply chain management*.

Several factors are driving an emphasis on supply chain management. First, the *low cost and increased availability of information resources* among entities in the supply chain allow easy linkages that eliminate time delays in the network. Second, the *level of competition* in both domestic and international markets requires organizations to be fast, agile, and flexible. Third, *customer expectations and requirements* are becoming much more demanding. Fourth, the *ability of an organization's supply chain to identify and mitigate risk* minimizes disruptions in both supply and downstream product or services to mitigate the impact on lost sales. As customer demands increase, organizations and their suppliers must be responsive or face the prospect of losing market share. Competition today is no longer between firms; it is between the supply chains of those firms. The companies that configure the best supply chains will be the market winners and gain competitive advantage.

## Why Purchasing Is Important

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### Increasing Value and Savings

As companies struggle to increase customer value by improving performance, many companies are turning their attention to purchasing and supply management. Consider, for example, CSX, the company featured at the beginning of this chapter. Almost 45 percent of the total sales of CSX is expended with suppliers for the purchase of materials and services. It does not take a financial genius to realize the impact that suppliers can have on a firm's total cost. Furthermore, many features that make their way into final products originate with suppliers. The supply base is an important part of the supply chain. Supplier capabilities can help differentiate a producer's final good or service, increasing their value to the final customer.

In the manufacturing sector, the percentage of purchases to sales averages 55 percent. This means that for every dollar of revenue collected on goods and services sales, more than half goes back to suppliers. It is not difficult to see why purchasing is clearly a major area for cost savings. Cost savings also encompasses avoiding costs through early involvement with design and proactively responding to supplier requests for price increases.

### Building Relationships and Driving Innovation

As mentioned above, savings come in different forms; the traditional approach is to bargain hard for price reductions. A newer approach is to build relations with suppliers to jointly pull costs out of the product or service and expect suppliers to contribute innovative ideas that continually add value to a firm's products and services.

Examples of supply managers building these relationships are occurring in many industries. For example, that's what happened a few years ago when two senior executives, one from Shell and one from Hewlett-Packard (HP), were having a conversation. HP is a strategic supplier of end-user services, service desk, and hardware to Shell and, as part of Shell's focus on supplier relationship management, the executives meet to discuss business value. Because both companies focus on innovation, the conversation eventually turned to what's new in R&D. The HP executive talked about research into a new wireless printer head the size of a postage stamp that works by picking up vibrations (using sensing technology). The information piqued Shell's interest because its deep-water oil explorations use sensing technology to discover rock formations that could hold oil several miles under the ocean. That simple conversation sparked a collaboration between the two companies to produce a system to sense, collect, and store geophysical data.<sup>3</sup>

David H. Cummins, senior supplier manager, strategic sourcing for Shell Global Projects U.S. in Houston, says the example proves that dedication to uncovering supplier value and capabilities is a never-ending process. "The value that was uncovered was part of a conversation that had nothing to do with the current services provided," he says. "Finding hidden capabilities is about putting each other's brains to work on challenges and to come up with something that is new and tangible. Very often capabilities are revealed when you are having deep conversations about mutual interests."<sup>4</sup>

For these relationships to work, both the buyer and supplier must agree to acceptable paybacks from their investments so that each realizes a positive gain. If the suppliers' strategic intent is to be the customer of choice, then they need to provide necessary technical infrastructure to assist the buyer. As the above example illustrates, when both parties cooperate, a climate of trust emerges between the parties setting the stage for innovative ideas.

## Improving Quality and Reputation

Purchasing and supply management also has a major impact on product and service quality. In many cases, companies are seeking to increase the proportion of parts, components, and services they outsource in order to concentrate on their own areas of specialization and competence. This further increases the importance of the relationships among purchasing, external suppliers, and quality. The following example illustrates this important link between supplier quality and product quality. Lululemon Athletica is a provider of high-end yoga pants and other athletic gear for women. The company experienced vibrant growth in its athletic apparel until supplier quality problems created a "brand nightmare." In March of 2013, the apparel maker had to recall its yoga pants as they were too "shear." This sheerness created a "see through" look that did not sit well with high-end consumers who had paid a premium for the product. Lululemon's supplier claimed it was making the pants in accordance with the specifications. The results showed otherwise and eliminating the sheer pants from the market proved more difficult than expected. While steps have been taken to correct the problem, the toll on the company has been significant. In June of 2013 came the announcement that CEO Christine Day would leave her position. Lululemon's stock price was also affected by both these events, and it slid from \$79 a share earlier in the year to \$61 in late June of 2013.<sup>5</sup> This example illustrates the importance of the supplier quality in the selection process and how a poor quality input affects the entire supply chain, including finished product and brand name reputation. This example further illustrates how lapses in managing supplier quality can potentially tarnish a firm's reputation.