



Procurement Principles and Management

Eleventh Edition

Peter Baily
David Farmer
Barry Crocker
David Jessop
David Jones

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Preface

The original text was written over 40 years ago by Peter Baily and David Farmer and was in its day one of a very small number of specialised texts relating to the field of purchasing and supply. Since that time, purchasing and supply chain management has become recognised as a crucial strategic activity by those concerned with organisational management and as a recognised academic discipline with a growing number of university professors dedicated to the subject area. It is reassuring to note that the literature on the subject continues to expand, as does the amount of academic and practitioner interest in it, reflected in the now substantial number of university degrees available at both under- and postgraduate level. As we also said, the visionary and pioneering work that Peter and David took part in, probably to some extent as a gesture of faith, is now fully justified.

The book could not have survived for this length of time without continuous change, and of course the idea behind this new edition is to continue that process. It should be pointed out that the change process is evolutionary, and that we have taken care to balance the newer philosophies emerging in our profession with the proven and established thinking and practice. This book is not of the ‘read this and it will change your life’ genre; rather it is, we hope, a reflection of sound mainstream practice, accompanied by comment on the way things seem to be going, and by insights into developing ideas and approaches.

This eleventh edition has been substantially updated with many additions in the form of more detailed case studies, additional academic content and the inclusion of more practical examples of best practice in many key areas.

Revisions and additions

Specifically readers will note the following **new** elements:

- a new, thorough consideration of **contract law**;
- improvements in **negotiation**;
- additional material exploring **offshoring/onshoring**;
- a more thorough treatment of **performance measurement**;
- the inclusion of a section on **risk**;
- considerable expansion of **MRP, Lean and Agile** theories;

- more detailed coverage of ABC analysis, TCO, Kraljic, **supplier preferencing**, Bensaou, CSR-Triple Bottom Line concept;
- additional examples of **services/tangibles** procurement;
- **culture** has been given much more focus;
- **supplier appraisal** and **supplier relationship management (SRM)** have been expanded considerably.

We are very grateful for the contribution of Alexis Brooks CIMA and David Moore of Cranfield University to the revised Chapter 3 on the subject of buying for government and public services. We also thank Neil Fuller, a chief examiner for the Chartered Institute of Purchasing and Supply, for his help and advice, and for his contribution of material included in our treatment of the 'quality' theme. Finally, we thank Ray Carter for his permission for inclusion of 10 Cs and Paul Jackson for his permission for inclusion of the 'Three Pillars' article.

The book is, as before, organised into four parts. The first, on the theme of objectives and organisations and covering Chapters 1–3, deals with the scope of purchasing activity and its evolution, relevant strategic issues and considerations, the structure and organisation of procurement, and public sector procurement. The second part, Chapters 4–10, looks at the key purchasing variables of quality, inventory, lead time, sourcing, total cost of ownership and price and negotiation. Part 3, Chapters 11–17, concerns itself with important purchasing activities and applications, dealing with processes associated with buying in particular markets or economic sectors. The final part, covering Chapters 18 and 19, deals with e-procurement systems and contract management (including contract law) and measurement.

We continue to hope that the book will appeal to those in the practitioner and academic communities. We have attempted to strike a balance between the demands of a pure academic text and the sometimes simplistic treatment of ideas encountered in the literature aimed at managers.

We are grateful for the help and support of many colleagues and friends who have contributed in a great variety of ways to the book, and to the copyright holders of some of the included material. Specific acknowledgements are, of course, made at the appropriate points in the text.

Barry Crocker

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■ Text

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Part 1

Procurement objectives and development

Chapter 1 Procurement scope and development

**Chapter 2 Strategic procurement and supply chain
management**

Chapter 3 Public sector procurement

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1

Procurement scope and development

Introduction

All organisations need inputs of goods and services from external suppliers or providers. In this chapter we examine the developing role of the purchasing and supply function in managing these inputs, and comment upon the ways in which the activity can contribute to the efficiency and effectiveness of the organisation, offering mini case studies demonstrating how companies are developing their purchasing/procurement contribution. We will identify ways of measuring the stage of development reached by an organisation and demonstrate how the development stage reached can affect performance of the purchasing activity.

Objectives of this chapter

- To discuss the scope of purchasing
- To identify the purchasing cycle concept
- To discuss purchasing and supply as a service activity
- To discuss the changing role of purchasing and supply
- To explain how purchasing might develop from an independent function to an integrated activity
- To identify the internal and external influences that have affected the evolution of purchasing
- To examine the 'total acquisition cost' concept
- To consider the adoption of relationships based on mutual benefits as an alternative to the traditional transactional, adversarial approach
- To highlight the evolution of concepts relating to purchasing development
- To identify key practices encountered in developed strategic purchasing
- To provide mini case studies demonstrating how companies are developing their purchasing functions

The scope of purchasing

A well-known statement of the objectives of purchasing is: to acquire the right quality of material, at the right time, in the right quantity, from the right source, at the right price. This statement is criticised by some as being rather superficial and simplistic. This is undoubtedly a valid comment, though the definition does provide a practical starting point for discussion. For present purposes, the following broad statement of objectives is suggested:

- To supply the organisation with a flow of materials and services to meet its needs.
- To ensure continuity of supply by maintaining effective relationships with existing sources and by developing other sources of supply either as alternatives or to meet emerging or planned needs.
- To buy efficiently and wisely, obtaining by ethical means the best value for every pound spent.
- To maintain sound cooperative relationships with other departments, providing information and advice as necessary to ensure the effective operation of the organisation as a whole.
- To develop staff, policies, procedures and organisation to ensure the achievement of these objectives.

Mini case study – Hertz

Buyers have been urged to remember their business's overall strategy when trying to transform their procurement.

If procurement cannot align itself with what the organisation wants to achieve, it will not get the support for what it wants.

Case study – Nokia

Nokia re-examines its purchasing structure every year as part of its strategic review. In spring 2003, it dismantled the company's global category buying structure for indirect spend. The worldwide approach had been put in place for direct spend, which has global markets. But as the market for indirect spend varies from region to region, a local group was set up for each of Nokia's four global groups in London, Finland, Singapore and the US.

Research

Purchasing departments continue to operate in ‘silo’, with over half failing to fully integrate into their organisation.

That is one of the findings of a research study by Bristol Business School, commissioned by Oracle, **The Chartered Institute of Purchasing and Supply (CIPS)** and the Office of Government Commerce.

While 93 per cent of businesses had a formal purchasing department, just under half had buyers with specialist commodity experience. This was significant because departments with this experience were more likely to have greater market knowledge, have better supplier relationships and achieve greater savings than generalist buyers. It was also an indication of investment in professional development.

Only 18 per cent of public sector respondents had a seat on the board, compared to 37 per cent of those in the private sector.

In addition, we might add some more specific objectives such as:

- To select the best suppliers in the market.
- To help generate the effective development of new products.
- To protect the company’s cost structure.
- To maintain the correct quality/value balance.
- To monitor supply market trends.
- To negotiate effectively in order to work with suppliers who will seek mutual benefit through economically superior performance.
- To adopt environmentally responsible supply management.

Case study – Ford

Purchasing and supply management for many is now directly linked into their companies’ business strategies and they recognise that it has a real impact on competitive advantage.

Ford Motor Company believes that procurement controls the ultimate profitability of the company.

Another viewpoint is summarised by Scheuing (1998) as follows:

Twenty-first-century perspectives for procurement

1. Function will be sourcing* not purchasing	10. Long-term contracts to establish relationships	19. Benchmarking of best practice
2. A vision of competitiveness	11. Emphasise continuous improvements	20. Internal customer focus
3. Driven by customer requirement	12. Mutual cost management	21. Service level agreements established
4. Emphasising value creation	13. Early involvement in new product developments	22. Purchasing leadership/empowered teams
5. Suppliers seen as external sources of ideas/technologies/time compression	14. Skilled professionals in purchasing	23. Purchasing professionals involved in innovation
6. Bottom-line focus not price	15. Outsourcing non-core activities	24. Cross-functional teams involving internal stakeholders to build and lead supplier relationships
7. Enhance competitiveness by using supplier capabilities	16. State-of-the-art IT systems	25. Sourcing a major contributor to organisational performance
8. Global sourcing	17. Purchasing involved in all non-direct spend	
9. Strategic alliances with key partners	18. Dramatic cycle-time reduction	

(Source: After Scheuing, 1998)

Note: * Actually purchasing has become procurement in many world-class organisations.

In summary, firms need access to competitive and productive supply markets if they are to be in business at all. The trend is from tactical to strategic procurement, establishing collaborative relationships with external resources and securing major business advantage from procurement.

Many executives are now looking to procurement to engage in strategic conversations about how supply chains can be improved to deliver the greatest returns.

In fact, according to KPMG’s ‘Power of Procurement’ study, many functions have struggled to raise their game beyond simple tactical activity and (re)negotiating low-cost contracts, to a broader and more strategic role within the wider business.

Procurement generally influences less than 60 per cent of spend across both direct and indirect categories. It has been slow to evolve or has struggled to make an impact because teams operate in a manner that inhibits their ability to become trusted business partners. By having the correct organisational design and processes, common issues such as poor service levels and performance, fragmented resources, or even insufficient skills can be overcome.

The best way to answer this is by looking at what transformation means from a procurement perspective. There are a variety of interpretations, but essentially

Research – Procurement evolution

The expectations of procurement are shifting, in that not so long ago, procurement was considered to be an add-on service; it was the business that decided which suppliers were core to the organisation and little more was expected of procurement than to battle some cost out of the contract and then hand the relationship back to the business to manage.

Today, many executives are increasingly looking to procurement to engage the business in strategic conversations about how the supply chain can be optimised to deliver the greatest returns.

Research shows, however, that there is still insufficient focus on ongoing supplier relationship management, little involvement in demand management, even less participation in the ‘make versus buy’ decision process and a dangerous lack of preparation, mitigation and action around supply chain risk.

The recent research shows that the majority of procurement functions still do not have a strategic role and are generally not considered as a true business partner to the organisation. In many cases, this is a direct outcome of ineffective governance, policies and procedures or a lack of appropriate procurement engagement during the early stages of the procurement process. As a result, those organisations are failing to make effective purchasing decisions, not fully leveraging their spend and economies of scale, and exposing themselves to business and commercial risk. So while early procurement involvement has been proven to deliver higher savings, the reality is that procurement is usually brought into the process to either close a deal or advise on the contract terms, when it is often far too late to add significant value – or often only when the commercial process has already broken down. The results also show that procurement is not placing sufficient focus on monitoring and tracking compliance across the organisation and is facing real challenges in maintaining control over both direct and indirect spend, and in supporting demand management activities.

it can be defined as organisational change management, designed to improve purchasing processes, activities and relationships.

As a general principle, this means that procurement transformation should address strategy and performance, the structure of resources and how it is organised, as well as improving the overall effectiveness of the systems supporting procurement. And finally, it must take into account governance and risk management to ensure compliance with business policy and legislation.

Three steps to success need to be negotiated.

- 1 The first is to establish a compelling case for change.
- 2 Second, a realistic and value-creating solution that supports the wider business vision and brings clarity of mind on the end goal, without straying into ‘nice to haves’ and idealism, needs to be designed.
- 3 The final element is to execute the transformation based on changing behaviour, culture and mind-sets.

■ Critical success factors – points to consider

Procurement transformations require a clear vision from the top, an unswerving desire to make it happen and commitment from everyone to ensure the changes are sustained over the long term.

All good chief purchasing officers (CPOs) continually challenge themselves to answer the questions: how well does my current strategy and organisation support the delivery of the organisation's strategy and objectives? Is this delivering the value it could? If the answer to one or both of these questions is not positive, you have the basis for a case for change.

■ The purchasing cycle

The main stages in the purchasing process may be summarised as follows:

- Recognition of need
- Specification
- Make-or-buy decision
- Source identification
- Source selection
- Contracting
- Contract management
- Receipt, possibly inspection
- Payment
- Fulfilment of need.

The idea of the purchasing cycle is often employed to indicate the main activities in which purchasing might be involved. The activities included in the cycle do not cover all of those that a purchasing staff might be involved with; there are many activities, such as negotiation, vendor rating and source development that are not specifically included. It will be noticed that, historically, the early and late stages in the cycle have not necessarily involved specialist purchasing staff, the core purchasing contribution to the cycle being the items included in the central part of the list. However, this has changed with early buyer involvement in design/specification work and greater involvement in ongoing contract management.

A limitation of the cycle concept is that it does not recognise the strategic contribution made by modern purchasing. (We shall discuss this contribution within this chapter and more thoroughly in Chapter 2.)

■ Is purchasing a service activity?

The thinking prevalent at the time of the first edition of this book was that purchasing was a service function, often subordinated to production or engineering in the manufacturing sector, or to finance in the service or public sectors. The idea was that specialist supplies staff could do the bidding of the more strategic elements of the organisation, and employ their skills at a secondary 'support' level. Thinking moved on, and there came a more general realisation that purchasing might contribute more effectively at a strategic as well as at an operational level. The idea that purchasing and supply was merely a support activity has been somewhat discredited, with a developing recognition

that purchasing involvement in issues such as the ‘make or buy’ decision or strategic commercial relationship gave the function a central and strategic role in the competitive organisation.

Syson has stated that purchasing has been transformed from a service function whose aims were expressed in the price, quality and delivery equation to one that makes a contribution to sustainable competitive advantage by reducing the cost of ownership, cycle-time reduction and improving time to market.

Simply to improve service levels or to cut costs is no longer enough. Purchasing must focus on its relationship to end-market performance. In many cases, purchasing has moved through *evolution* of its role to *devolution* of much of the more straightforward buying activity, while retaining and developing its strategic contribution.

Research in 2006 (The 2006 Global Spend Agenda – The Ariba Study)

Three hundred and twenty-five purchasing heads from large organisations in Europe and the US revealed that there is an emergence of two groups of companies; one takes a rather conservative, traditional ‘bookkeeper’ approach while others are more bullish in their enthusiasm for innovation and aggressive cost reduction targets.

The bookkeepers are lagging because they do not have the strategic drive to know where they are going or how to get there. The study therefore concludes that purchasing has to be innovative in structure and strategy so that it can really grapple with complex spend categories, off-contract spend and compliance issues such as: almost two-thirds (59 per cent) of suppliers working outside negotiated contracts and rogue spending occurring in 77 per cent of businesses in Europe and 81 per cent in the US. The study also found that procurement departments are still trying to reduce their supply base and still struggle with more complex spend areas such as services.

The changing role of purchasing and supply

As we have indicated, purchasing is seen by many of today’s successful organisations as an activity of considerable strategic importance. The fact that the strategic role and contribution of purchasing and supply is well recognised in many leading commercial concerns has meant that the strategic purchasing decisions may be taken by purchasing involvement at board level, rather than by a departmental manager.

Mini case study – Nokia

The answer to whether procurement is strategic is yes, if one considers strategic contribution to an organisation to be any activity that drives market penetration, revenue growth, profit maximisation and shareholder value. For any function, including procurement, to be considered strategic, it must align itself directly with these organisational priorities.