CSCMP COUNCIL OF SUPPLY CHAIN MANAGEMENT PROFESSIONALS

THE DEFINITIVE GUIDE TO SUPPLY MANAGEMENT AND PROCUREMENT

Principles and Strategies for Establishing Efficient, Effective, and Sustainable Supply Management Operations

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Many companies can provide the products and services in the *leverage* category; these are the more commodity-type items. Items classified here have a high-level of spend making them important to the organization and the suppliers that provide these items into a preferred category.

Case in Point—Leverage

A lot of variety exists in the types of items classified as *leverage* items at each organization. One that is relatively common is that of packaging. Many packaging suppliers are available, so if necessary volumes between suppliers can be shifted or one can be dropped from the supply base because of poor performance. Items in this category are important to the organization because of the high volumes and level of spend. Suppliers in this category have a different type of relationship than the noncritical and try to leverage their expertise to gain more business. Logistics suppliers, packaging suppliers, and others that fall in this category generally gain a competitive edge through their relationship, which is built on trust and performance. The buyers and suppliers work collaboratively together to reduce the costs associated with making these materials with the intent to drive down prices.

Strategic or *critical items* have more complexity and risk involved in the purchase. This is often due to limited availability (that is, resource scarcity) and fewer capable suppliers. These are typically items that you need to ensure continuity of supply for your customers. Buying firms enter into long, cost-based contracts with the suppliers in these firms and may engage the suppliers early in the process of new product development. These supplier relationships are strategic.

Case in Point—Strategic

The all-wood furniture company has one commodity that it considers strategic: lumber. If the lumber is not available, the company cannot produce its products. The lumber suppliers are strategic and the relationships are long term. Because lumber is a natural resource, it is subject to natural scarcity. During times of scarcity, it is the suppliers that help the manufacturer to continue its processes. The manufacturer often talks to the supplier about inventory level, purchasing, quality standards, and so on. The supplier suggests innovative and cost-saving ideas.

Bottleneck items are typically project-oriented or unique and often require niche suppliers—for example a large piece of equipment used in mining. There is a high level of market complexity, and the management of these items is often difficult and time-consuming. The relationship is usually more transactional.

Case in Point—Bottleneck

These items are extremely time-consuming for purchasers to manage. Often they are individual projects, for example, the purchasing of equipment for a manufacturer. It takes a long time from the initial idea to delivery; few suppliers of each type of machine are available; and the logistics are challenging. IT systems can fit in this category, where the investment costs are high and the implementation is time-consuming.

Supplier Analysis

Supplier analysis is used after the portfolio analysis is complete. After this assessment, the team can make supplier recommendations. Purchasing has to identify current and potential suppliers, determine any information technology requirements, and identify opportunities to leverage the commodity expenditures with similar commodities (leverage volume and consolidate spend). The identification process and important supplier requirements can vary depending on the type of commodity, how important it is to the organization, and how much risk is associated with its purchase. The criteria may also assess capabilities to meet future goals. Many categories can be considered depending on the needs of your organization; however, some of the major categories are

- Price, cost, total cost
- Financial condition/viability/performance
- Process and design capabilities
- Management capability
- Planning and control systems
- Quality management systems
- Technical capability
- Environmental regulation compliance
- Social/ethical behavior
- Capacity

- Relationship potential
- Certifications

The criteria are both objective and subjective, and each major category has subcategories and weights (level of importance) associated with it, as discussed in Chapter 1. Each supplier is assessed or scored on the important criteria. You should use the sum of the total weights to determine potential suppliers. These criteria are generally developed in tandem with other stakeholders and weighted in terms of importance to the organization.

An example of a weighted factor rating approach is included in Figure 2-7. The weighted calculation is the score divided by scale multiplied by subweight. Sum each category and then add up those category totals. Ultimately, you can use these criteria to select the supplier and to measure and manage supplier performance.

Supplier: R&M Components					
Category	*Weight*	*Subweight*	*Score (5 point scale)*	*Weight Score*	*Total*
1. Quality Systems	20				
Process control systems		5	4	4	
Quality Certification (IS O14000)		8	4	6.4	**17.4**
Parts-per-million defect performance		7	5	7	
2. Management Quality	10				
Management/labor relations		5	4	4	**8**
Management capability		5	4	4	
3. Financial Condition	10				
Debt structure		5	3	3	**7**
Turnover ratios		5	4	4	
4. Cost Structure	12				
Cost relative to industry		4	5	4	**11.2**
Understanding of costs		4	4	3.2	
Cost control/reduction efforts		4	5	4	
5. Delivery Performance	12				
Performance to promise		4	3	2.4	**7.2**
Lead-time requirements		4	3	2.4	
Responsiveness		4	3	2.4	
6. Technical/Process Capability	18				
Product innovation		5	4	4	**15.4**
Process innovation		5	5	5	
Research and development		4	5	4	
Technological Innovation		4	3	2.4	
7. Information on Systems Capability	12				
EDI capability		4	5	4	**8.8**
CAD/CAM		2	0	0	
e sourcing capabilities		6	4	4.8	
8. General	6				
Support of minority suppliers		2	3	1.2	**4.8**
Environmental compliance		2	5	2	
Supplier's supply base management		2	4	1.6	
				Total Weighted	**79.8**

Figure 2-7 Supplier scorecard, R&M components[16]

Supplier Evaluation and Selection

Most purchasing experts agree that there is no one best way to evaluate and select suppliers, and organizations use a variety of different approaches. Regardless of the approach employed, the overall objective of the evaluation process should be to reduce purchase risk and maximize overall value to the purchaser. Most corporations have a standardized supplier evaluation and selection process; the verbiage and number of steps may be different, but the activities within each step are similar.

1. **Recognize the need for supplier selection.** Many reasons exist for an evaluation and selection decision. For example, new product development requires a new pool of suppliers. You need to consider many issues such as current supplier capacity or performance. Building new facilities or moving facilities to a different location can also require new suppliers.
2. **Develop a cross-functional sourcing team.** After a need is identified, the people with an interest in a successful sourcing event must be identified and begin work as a cross-functional team. This team works closely together in identifying, selecting. and evaluating suppliers. Typically, members of cross-functional teams are evaluated on joint metrics (which are discussed in Chapter 6).
3. **Identify key sourcing requirements.** These are the major "knock-out" criteria for initial screening. For example, a supplier might be too small to meet your requirements. Perhaps they don't have the necessary capabilities. Potentially they are struggling financially and are too much of a risk. The sourcing team determines what is important, and these criteria are used during the initial screening stage.
4. **Determine sourcing strategy.** This has to align with both corporate strategy and fit within the parameters of the other work already completed during earlier assessments. For example, is this a short-term or long-term relationship? Will the supplier be domestic, nearshore, or offshore? Will this be a sole source situation, or is that too risky of a proposition?
5. **Identify potential sources for supply.** Depending on the classification of the commodity, more or less time might be involved at this step. The more strategic the item and the lower the capabilities of the current suppliers, the more time is spent here. The team is responsible for gathering a pool of suppliers that can provide the good or service within the specified parameters.
6. **Limit suppliers in the selection pool.** This step occurs as the information is gathered and the critical issues are assessed. The purchaser may have many potential sources from which to choose but the performance capabilities of suppliers vary. As discussed in earlier sections, the key here is to understand the subjective and

objective criteria that are most important for the commodity or service purchased. An in-depth financial risk analysis of each potential supplier is also necessary. When the pool is at a point that it is manageable, supplier site visits might help to eliminate some of the remaining contenders.

Following are potential financial metrics/measures for risk assessment and supplier evaluation:

- Credit rating
- Average collection period in days
- Stock price
- Average accounts payable in days
- Return on Investment (ROI)
- Inventory turnover
- Cash flow
- Average days in inventory
- Working capital
- Fixed asset turnover
- Current and quick ratio
- Return on assets
- Profit and operating profit margin
- Return on equity
- Debt to equity
- Times interest earned
- Cash to cash cycle
- Year over year change in costs versus change in revenue
- Gross margin ROI

7. **Determine the method of supplier evaluation and selection.** At this stage, the pool of available suppliers is more manageable. The team has to decide how to evaluate this smaller pool of suppliers. A well-structured site visit is highly recommended to each of the remaining capable suppliers. However, the decision to visit all suppliers requires a commitment of resources that are sometimes not available.

8. **Select supplier and reach agreement.** After all the assessment, much discussion among group members, and an analysis of supplier "fit" with the buying organization, the supplier is selected. It is time to work on the negotiation and ensure that all the specifications are accurate.

Contract Negotiation and Management

Negotiation is an exploratory and bargaining process (planning, reviewing, analyzing, and compromising) involving a buyer and seller, each with her own viewpoints and objectives. The goal of negotiation is to reach a mutually satisfactory agreement on all phases of a procurement transaction—including (but not limited to) price, service, specifications, technical and quality requirement, freight, and payment terms. Not all commodities or services require negotiations, so the decision to negotiate relies on the effective classification of the goods and service in the commodity matrix.

The basic steps in the negotiation process are listed next.[17] As with many purchasing activities, it is a cross-functional team effort. Other team members might include cost accountants, engineers, business analysts, and others.

1. **Select the team and assign the chief negotiator.** The team is there for backup, often performs data analysis, and helps the primary negotiator make decisions.
2. **Determine objectives, including a win-win outcome for both parties.** A win-win is important if the relationship with the supplier is key, for example, if this supplier will receive a high volume of business, or the supplier has a key technology available. If suppliers feel like the situation is not a win for both, they either will not accept your business, or you may have a potential trade-off with quality.
3. **Prepare for the negotiation by looking at comparative bids, potentially going on a site visit, and assessing industry price trends.** (Information is power, so the more you can find out, the better.) During this stage the purchaser should develop a proposal, think about potential questions from the supplier, and gather any information on past purchases with the supplier. Establishing an objective target for price and putting boundaries on it can help to control the negotiation.
4. **Determine bargaining strength, and think about the bargaining strength of the supplier.** Go back to the data collected during the market assessment to see if you can understand who is in the position of power.
5. **Plan the agenda, the place, the time, and the minimum and maximum positions.** The better the plan and the more information available can help establish a position of authority.