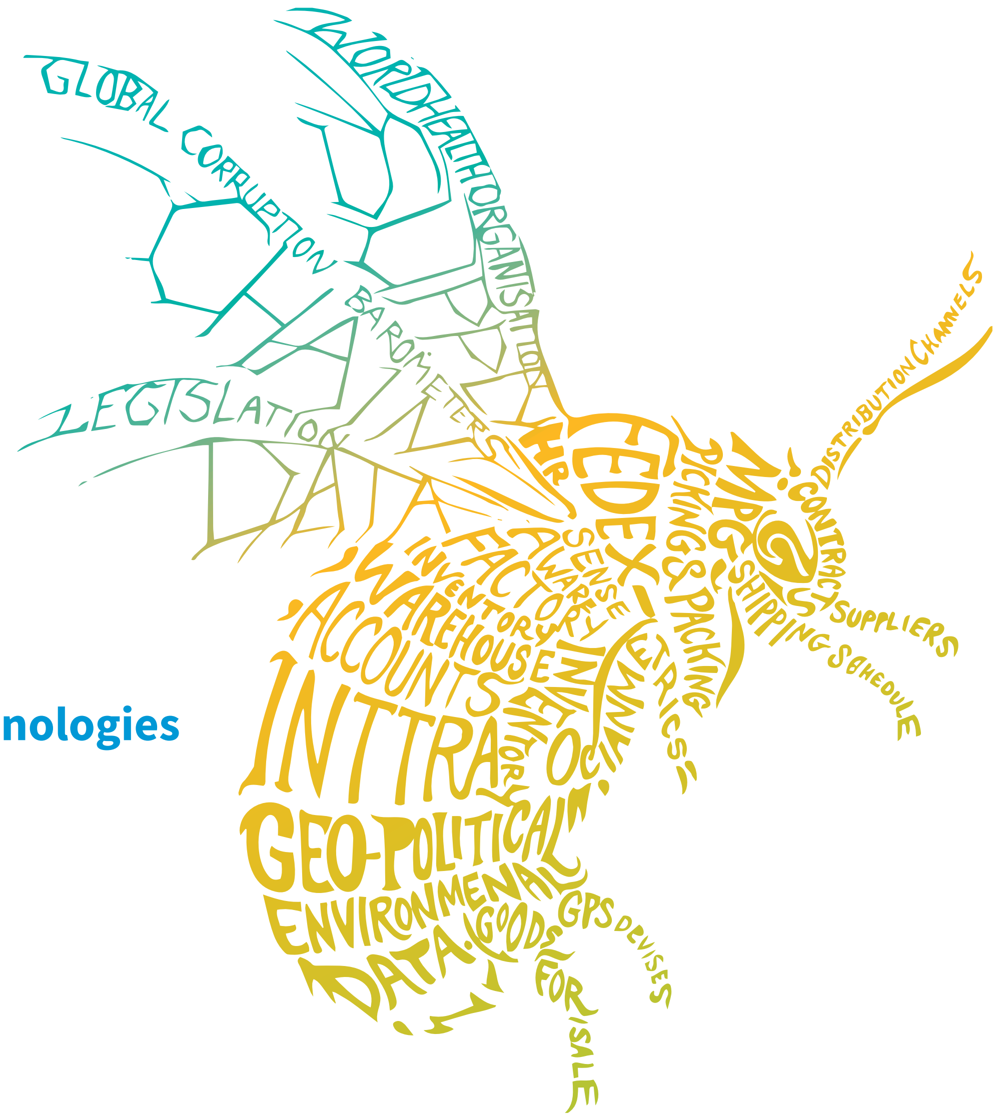
Supplier Performance: Is it time for a new metric?

Learn how to create more business value by changing how you engage with your suppliers.



A **Rosslyn Data Technologies** White Paper

Opportunity cost, that fundamental principle of economics, has a lot to answer for when you get down to how one business thinks about the others around it. Ask a salesman what the opportunity cost of any activity is and you'd (rightly) be asked how much the client has to spend. Ask any individual involved in purchasing and you'll more likely get a set of criteria of what they feel constitutes good value, the cost being the resources taken to make sure that's what they get.

Are you getting a good price? Does the product meet quality standards? Safety standards? Specifications? The opportunity cost of buying something appears to be, on the surface, quite a simple equation, predicated on the least cost within a framework. But this kind of thinking undermines every point of interaction between buyers and suppliers. It limits you to certain conversations and encouraging certain kinds of behaviour that ultimately prevent your organization from getting the most from suppliers.

ROI: Restrictive or Invaluable?

The answer, for some, is in bringing everything, including sourcing and supplier management decisions, back to the ROI. As a concept, Return-on-Investment (ROI) has been used as a decisionmaking factor for businesses the world over, but the problem is that in practice it acts like the visible portion of a huge iceberg: what actually constitutes a return and how you measure it adds hidden depth and complexity to an apparently simple equation.

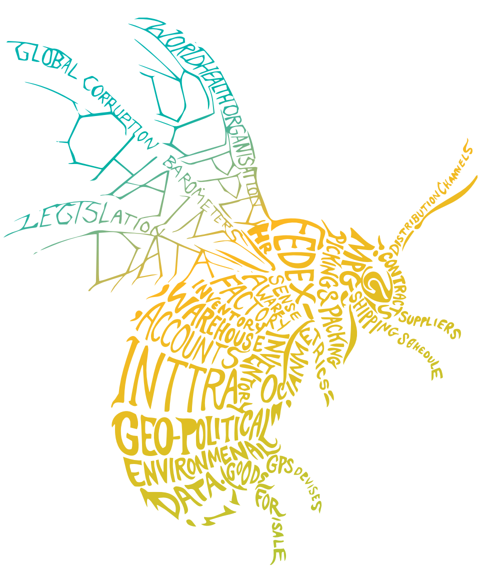
Businesses need to get more hands-on with their analysis of suppliers' performance and avoid overly simplistic thinking that continually pins performance to a narrow set of metrics. With a more holistic focus and better data, engaging with suppliers becomes an exercise driven by creating value: according to a study by industry commentators Spend Matters, "the lack of consistent, high-quality supplier information is costing the typical Global 2,000 company tens to hundreds of millions of dollars – annually."

Many organizations employ a simple performance matrix to determine if suppliers are meeting the criteria set – but that kind of tool limits the understanding of performance to the purchaser's set of minimum standards. It ignores the capabilities of suppliers, the potential to add value, focusing on the boxes they are ticking rather than the benefits they could be delivering. That approach has several implications for what businesses receive from their suppliers...

Flaws in the metric system

Suppliers learn how to say the right things

Filling those tick boxes has become something of a past time for businesses. If you possibly can work out a way to say you comply with a general requirement, no matter how much creativity of thought that requires, there's a chance you will. When you look at environmental performance, say, there's any number of ways to hide undesirable practices behind statistics – the existence of child labour in global supply chains (still a huge problem according to wider studies by human rights organizations) would never be evident in a tier-1 supplier report, for example.



It's not connected to spend data

The information procurement gets from its suppliers is at best unhelpful and at worst misleading unless it's cleaned and enriched with the kind of spend data that can place a piece of information into the context of business performance. A basic supplier scorecard can be a binary affair - is supplier x performing to standard y – but that won't necessarily tell you much about the relationship with x, or the implications of y. It's an inefficient process which will ultimately weigh down a purchasing organization as spend analytics software continues to want to interrogate supplier performance data to improve its own effectiveness.

You don't get what you actually need

If we get down to the point of measuring suppliers, partly it might be to detect compliance and engage in due diligence, while in part it might be to better understand areas for improvement. But the real opportunity lies in learning where suppliers can give you more - be it innovation, insight or efficiency. More malleable measures are required if we're to learn anything about the journey of suppliers towards these kinds of goals. So a supplier reduced costs by 3%, what if competitors are collaborating with that same supplier on the transport of the goods they supply and making significantly more savings in efficiencies there? Your measurement tells you one truth, but may miss the point.

Developing metrics to drive performance

Let's change the game and look instead at what suppliers could be delivering. Here are six tangible examples of how supplier performance can contribute to your organization's bottom and top-line performance. It requires you looking beyond traditional metrics and into a fast paced world where your suppliers aren't vendors, but partners. It also requires you to re-evaluate the approach to managing supplier performance so you're able to create new opportunities that bear relevance to key levers into the organization.

Creating bottom-line value

1

From risk mitigation to supply chain resilience

For some industries (oil and gas being an obvious example due to the reliance on the quality of supply) risk has been an important component of discussions with suppliers, ingrained into the supply chain strategy. Car manufacturing might be another example - supplier failures, not just in terms of quality of supply, but also in terms of the financial health of a small supplier of a crucial part can have a big impact on a final product and an overall brand.

In both of those cases, the right information and the right lever to create supplier improvement (where required) is the difference between managing risk and reacting to risk.

The problem is ultimately that a business inherits its suppliers' risks and, unless it manages those risks with the same rigor as it manages its own, it bears the brunt of their failings. A simple compliance metric may not deliver this depth of investigation, which means relying on the tier-1s to do a thorough job of measuring the tier-2s, and so on. If there are vulnerabilities, be they industry-wide, deep in the supply chain, or an issue with compliance, it's only through enriched data and analytics capabilities that those will be apparent.

New metrics:

- Commercial performance against difficult conditions: In order to understand resilience, we need to understand performance in the face of risk. How have suppliers' quality and delivery standards been affected in times of economic hardship in the industry? Commercial performance deviation – sales figures, price changes, order fulfilment – as tracked against a basket of key market performance indicators could tell us how well suppliers respond to pressure.
- Robustness of compliance programme: Knowing the frequency and magnitude of tier 2 supplier failures – be they CSR incidents, quality incidents or contract breaches – can tell us a lot about the relevant tier 1 supplier's vulnerability and its ability to bring about compliance.

2

Stop talking cost and start talking total cost

Down the years, it's been an accepted route to savings to go to a strategic supplier and work with them to understand their cost drivers and where they might be able to take cost out and pass the savings on. In essence, this is an exercise in identifying value leakage in the supply chain, but it's also an exercise in pulling apart the component inputs into a cost equation.

As a concept, procurement managers have long been looking to have a deeper perspective of the implicit costs in each decision they make. One supplier might be cheaper than another, for example, but are there greater compliance issues; does a move to outsource a service mean a drop in quality of responsiveness; how viable is a supplier in a market where currency rates are vulnerable to large shifts – these have the potential to be vital questions.

In order to understand how a relationship hits the bottom line, it's necessary to have metrics that look beyond simply how much suppliers are being paid and starts looking at where that money is going and what's driving that.

New metrics:

- Savings passed on from suppliers' effective procurement: Procurement is frequently afforded very little space on an annual report – reductions in third party costs may be recorded, but they don't tell the whole story. Having visibility of metrics around suppliers' performance in reducing spend and delivering cost savings can indicate whether your suppliers are an organization making efficient cost-smart decisions and passing the savings on, or even whether there's room for supplier development around procurement to help take further cost out and pass those savings up the value chain.
- Collaboration to manage duplication of demand: A global business might have many touch points with a large supplier, a global facilities management group, for example, but that doesn't necessarily mean it's an efficient relationship. Part of procurement's role lies in the simplification of these interactions; but as a metric we can understand how many times suppliers have engaged in transactions with a business and how many of those resulted in extra expense. For some suppliers, there's a sense that it's the customer's problem to work with them in an efficient way, but by assessing the frequency of uncoordinated interactions, it's possible to better demonstrate the cost incurred to

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Tackle the lingering sickness of inefficiency

Any professional has tales of inefficient relationships and processes that have existed for years, unaddressed because the people who would be shocked and appalled by their wastefulness either don't know about them, or are powerless to do anything about it.

Buying decisions aren't necessarily predicated on what's most cost-effective from the perspective of the overall organization and that means there's a gap for waste. It's up to procurement to oversee that touch point between suppliers and stakeholders - but without supplier performance data, the opportunity to seek efficiencies in the service of suppliers is often neglected in favour of what's simplest for the individual stakeholder.

Procurement can use data as a lever to show internal counterparts that there's opportunities to get much more out of their budgets, such as how to track and monitor inefficiencies.

New metrics:

- **Cost avoided:** The onus is often on procurement to identify instances of misaligned specifications, over-ordering, unnecessarily transporting a part round the world, when it could have been delivered down the road. If supplier performance can be thought of in terms, not just of the value of what's physically provided, but also by putting a cost figure on instances where a supplier had identified instances of inefficiency or misalignment, it could be possible to encourage a more collaborative approach to cost reduction.
- **Touch points with procurement and responsiveness:** Large suppliers can interact with your organization through many channels, clogging up payment processes with huge numbers of invoices and, more importantly, unnecessarily taking up resources to deal with. If we can begin to track the hours spent dealing with a supplier, be that in negotiating, processing, managing, developing, it's possible to develop a knowledge of the resource cost, beyond how much you actually pay them. In some instances the relationship with a supplier is hugely valuable, in others they may just be inefficient themselves and creating a waste of time – something you wouldn't know until you got a broader view of their performance.

Creating top-line value

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Understand what innovation is worth

It's a sign of an ambitious function for it to be looking to capture and record supplier innovation - whether it be contributions used to benefit R&D, or simply a more efficient form of getting the goods to the buyers' factories. But the process of tracking and measuring that contribution is still something of a frontier for many organizations – a combination of incentivization and governance; of translating good ideas into financial outcomes.

The possibilities of innovation are conceptually endless, but the reality is that unless you're prepared to understand your suppliers' approach to delivering solutions and efficiencies and how those create a benefit for you, or even for your competitors, it's difficult to get a grasp on what the cost of not managing that aspect of performance is.

By nature, those with the biggest chequebooks often get the pick of suppliers' innovative ideas, but for the astute, data-enhanced organization, there are always chances to collaborate and turn what you know into an activity that can drive competitiveness for you and your suppliers. If you don't, there's a chance your competitors will.

The supplier may not be big, perhaps sitting in the tail-end spend, but may be more important than a bigger one because they bring innovation. We see here that the metric must change in order to progress forward. By not changing the metric, companies don't change.

New metrics:

- Bringing new products to market: Innovation often boils down to taking out cost or creating revenue. By measuring the number of products brought to market with supplier inclusion, the revenues generated from supplier contribution, even the volume of usable ideas received – even if they're not ultimately implemented – a business can understand whether a supplier is or has the potential to make a huge difference to their product.
- Contribution relative to category/scale/product: Requiring to suppliers to provide innovation is never straightforward and certainly it varies from category to category. How well can an organization that runs the management of your offices help with innovation? By creating a weighted innovation score, it's possible to give context to performance by pitching what you might expect from a supplier against the frequency with which they offer qualified ideas to help your business add value for your customers.

5 Turn performance into a forecast for tomorrow's market

Locked away in every organization there are pockets of knowledge that, if they were theoretically combined, would give you a pretty rounded view of what was driving performance and where it was heading. The same could be said about any market: there are scraps of information - the kind that news agencies collect, which paint a broader picture.

As masters of information in the supplier market, a procurement function could understand the economic forces affecting the business with unparalleled insight. Anticipating rising costs may be a key part of the role of the function, but those kinds of shifts should never be analyzed in isolation; new technology making parts of industry obsolete, or dipping demand in China forcing machinery suppliers to refocus on Western markets, for example – the metrics tell a story that can inform everything from sourcing strategy to sales campaigns.

New metrics:

- Key economic indicators provided: Economic data is often shared after the fact - a price rise will tell you that your supplier's market has changed. That said, if you can reward your suppliers for the depth of data they're able to provide, it can encourage transparency and offer a view on the market. What are their market's payment terms, what regions have seen particular growth for them, what do they know about their suppliers' financial health? Measuring suppliers' ability to share their own metrics and financial data can encourage the provision of the kind of data that can feed be analysed and fed directly into the business.
- Stakeholder score of supplier as a provider of strategically useful information: Measuring supplier performance shouldn't be limited to asking suppliers how they're doing - stakeholders can provide satisfaction scores, and track instances where supplier data has resulted in a positive commercial outcome for their function. If a supplier of mops tells a building manager of an upcoming uptick in the expense of cleaning fluids, that can drive a purchasing decision which reduces cost.

6 Justify CSR claims with results

For some markets the social and environmental measures of a business, and its suppliers are a pressure like no other. For an organization looking to use its choice of suppliers from a CSR perspective as a differentiator over competitors, procurement's handling of performance and its sourcing activity may be some of the most influential decisions they ever make. For a long time, arguments over the ROI of green policies held companies back from making decisions that would ultimately recognize that low-cost sourcing was costing them sales.

There's little doubt now that effective metrics are needed to avoid the risks associated with bad headlines, but there's also increasing awareness that if businesses are to fulfil their promises of being responsible citizens of the business world, they need ways to manage whether and how suppliers achieve emissions targets, avoid wasteful purchasing, and help collaborate on green solutions. Stakeholders, customers, shareholders: the realization is taking place that in order to live up to lofty ideals and stay competitive; we need a way of tracking and then proving that suppliers are along for the ride.

New metrics:

- Waste-removing efficiencies/innovations delivered: Depending on the industry, procurement frequently has a responsibility to work with suppliers to meet a target for waste reduction - carbon emissions in manufactuSorted frring for example. Mostly that can come through scoring suppliers on ability to meet certain waste targets, however there's an opportunity to track the overall instances of reduction of waste and to understand that as a cumulative total, rather than a box which has to be ticked. If your supplier moves a factory closer to yours to reduce logistics costs and emissions, that should be recognized, even if it doesn't get covered by a more familiar scorecard.
- Suppliers' compliance to CSR standards: Many of the problems in adhering to CSR standards and not running into trouble with regulations stem from lack of visibility into the lower supply chain tiers. Metrics that help make sense of the success of suppliers' compliance levels – do they audit suppliers on CSR performance, what rate of compliance do they get among their tier- 1s (the purchaser's tier-2s) and what level of traceability do they have on each line item.

From supplier relationship management to supplier performance analytics

Supplier performance is much more about managing the relationship. Supplier performance is a strategic importance especially when you consider that, according to a report by Supply Chain Management Review, of companies reporting a financial estimate of benefits, the average figure is more than $100 million in incremental value from supplier relationship management.

The successful business of tomorrow won't be the one with a slight increase in revenue or profit margins. They will be the ones that are creating new and exciting opportunities in partnership with suppliers, resulting in market domination. This requires a fundamental shift in how organizations view a successful relationship with suppliers. It'll require new metrics and, most importantly, ripping up how you engage suppliers so both parties benefit.

The journey won't happen overnight. Yet, it does require establishing the foundation in which to build a new supplier engagement model built on data so you are able to make informed decision to shape the evolution of your supplier relationship program.

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