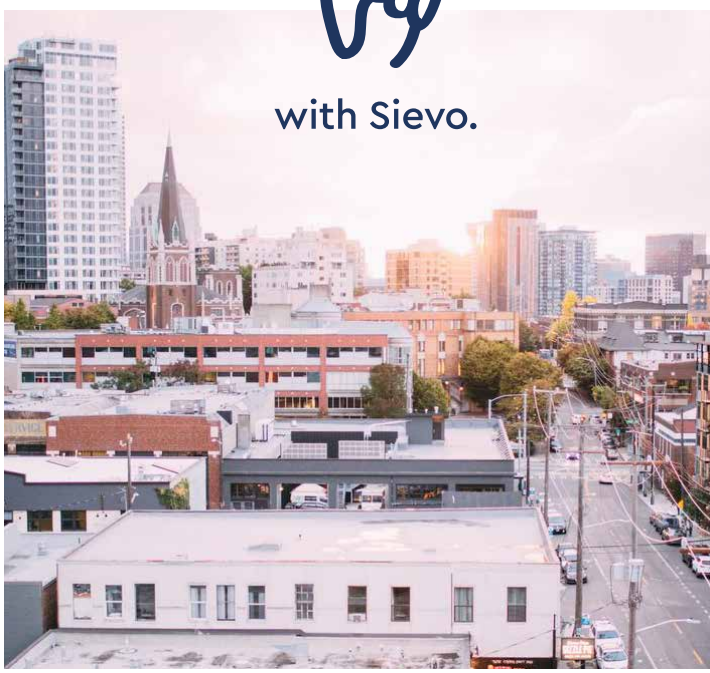

with Sievo.

PCF©
Procurement Contribution to Financial Performance

A method developed by Sievo

Sievo

Foreword

Over the last decade, the procurement function has grown in maturity and professionalism. Already considered as a strategic function in the industrial sector with CPOs now members of the executive committee, a similar development is being witnessed in financial and other services industries at large.

In parallel, an increasing number of educational degrees targeting the procurement profession come to complement the more traditional curriculums offered in technology, finance or economics. Now armed with a multifaceted education, the new purchaser possesses all the capabilities to face future procurement challenges.

The development of the function and its degree of recognition has also been made possible with advances in technologies. The availability of tools that automate, simplify and optimize purchasing processes has further allowed purchasing to advance in its development. Initially focused on price, quality and lead time, procurement has now become an important contributor in business strategy formulation to support overall value creation.

While the performance of procurement has undeniably increased, the financial community remains doubtful of the true contribution of procurement to the financial results of the enterprise. with the PCF (Procurement Contribution to Financials) concept developed by Sievo, CPos and CFOs alike can now determine the contributing factors of spend development year on year and hence truly determine the performance of procurement in financial terms. This new method finally allows a precise and undisputable calculation of procurement performance, opening a new avenue of recognition for the profession.

Alain Page-Lecuyer
Ex-CPO AXA Group

Genesis

The concept of Procurement Contribution to Financials (PCF) was born to fill a gap at the intersection of procurement and finance. Unlike sales, whose performance is measured by yearly turnover and turnover growth, procurement does not possess one universal formal measure for its contribution. strategy formulation to support overall value creation.

Objective

PCF aims to replace the many non-uniform measures that one can find within procurement with one formal, universally recognized and fair standard method.

Principles

1. **Formal**: PCF had to be a formal measure readable from companies' financial statements

2. **Universal**: PCF had to become a method applicable to both indirect and direct purhases independently of the business structure

3. **Fair**: PCF recognizes the measurable efforts of the procurement function

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I.

Understanding Procurement Contribution to the Business

The contribution of the procurement function to a business takes multiple forms. All are very important, but we will solely concentrate on its financial contribution.

Financial statements take a snapshot of business performance for a set time period. When the exercise closes, counters are set to zero on the P&L statement and Balance Sheets are "frozen" to depict the company's assets and liabilities at this point of time.

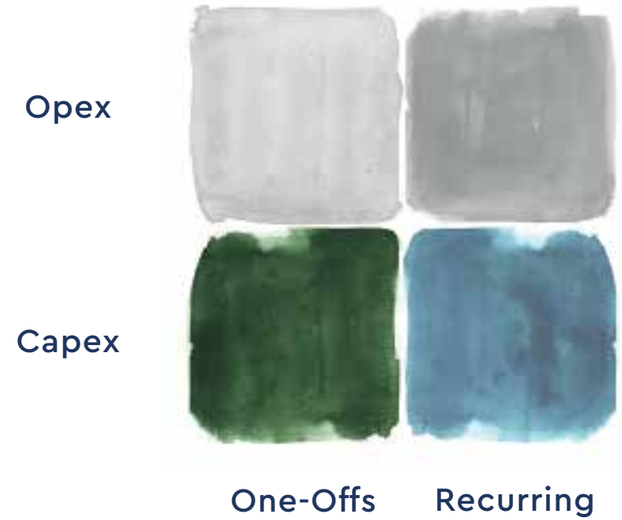
Measuring procurement contribution to financials ought to follow similar principles: align to the set financial period (Reference), account for flows during that period and that period only (Movements), close at the end of the period and reset counters at the beginning of the new period.

In this chapter we will establish the reference from where the financial contributions of procurement can be measured, the forms of financial contributions (Movements) and eventually set the Procurement Contribution to Financials (PCF) framework for reporting contribution.

Reference: external spend

Defining the reference for procurement contribution requires first understanding the external purchases procurement deals and their nature.

Reference for PCF: External Spend



The combined four squares represent total external purchases. In other words, it represents a company's total expenses to suppliers, excluding interest expenses and taxes.

The segmentation reveals that some purchases that procurement deals with will not be repeated as they are considered as "one-off".

It is also important to notice that what is being purchased could be classi-fied either as an operating expense accounted within a company's EBITDA; or a capital expenditure excluded from a company's EBITDA but visible through depreciation for part or in the assets register in full.

Contributions to one-offs, recurring, Opex and Capex ought therefore to be measured differently.

Movements: procurement contribution

As highlighted above, procurement contribution to financials gets meas-ured from one period to the other. In other words, movements within a set financial period are accounted for as procurement contribution.

Procurement contribution to "one-off" purchases exist, however, and by definition, the financial contribution of these from one period to another cannot be measured. Measures against budget or initial price quotation can be used as proxy to define the financial contribution which ought to be considered as cost avoidance.

In contrast with one-off purchases, procurement contribution from recurring purchases can be measured on a yearly basis. We call this contribution procurement savings.

Procurement savings on recurring purchases are to be fully accounted for in EBITDA development and hence can be reconciled with the company's P&L statement. This reconciliation is often considered as the "bottom line" impact of procurement.

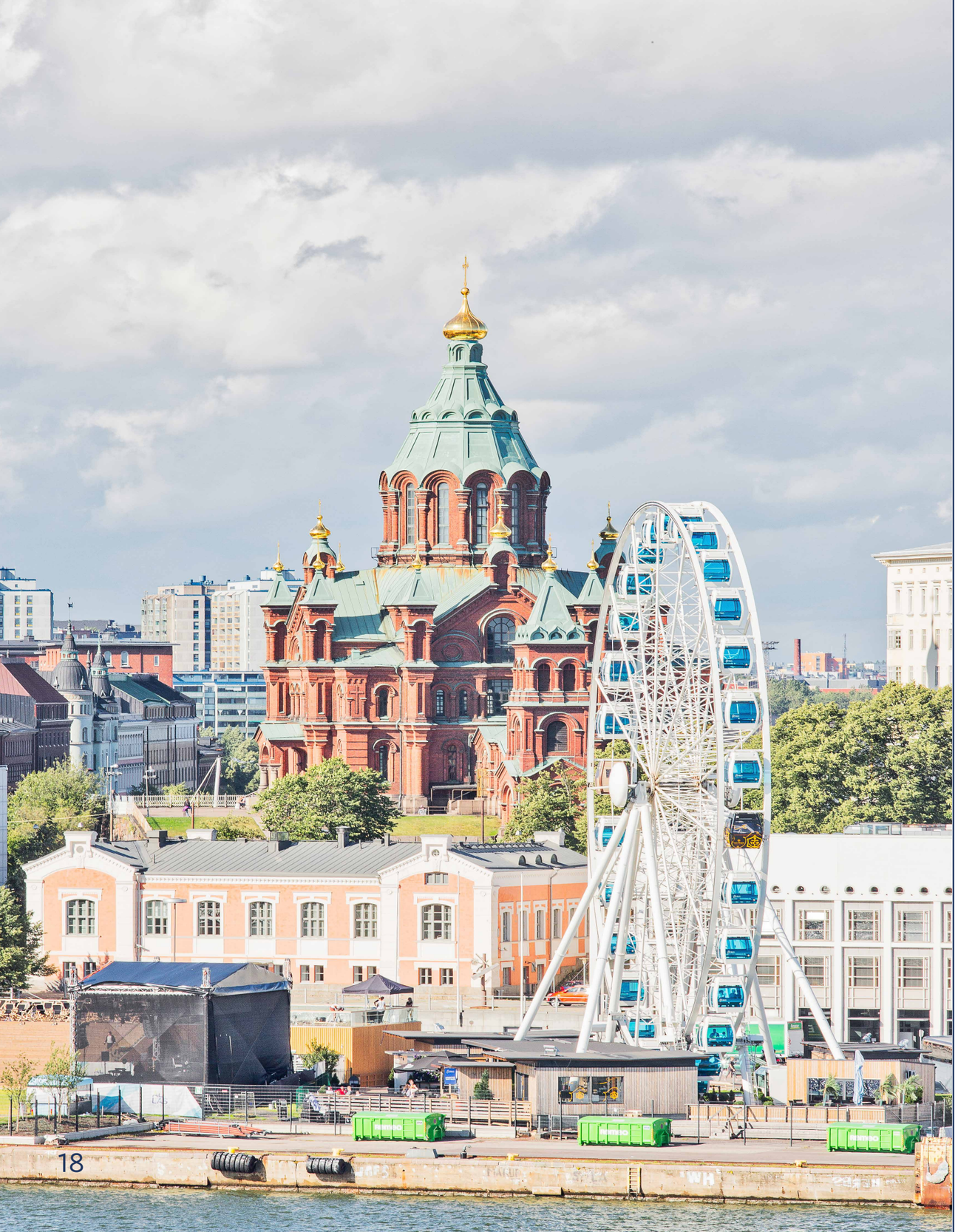
While procurement performance on operating expenses can be isolated within a company's EBITDA development, the effect of procurement on recurring capital expenditures cannot. Impact on depreciation or EBIT exists but as capital expenditures are often treated and valued separately, they lose traceability within the P&L.

PCF: mutually exclusive and collectively exhaustive

Establishing the procurement contribution to financials is recognizing the varying nature of purchases and hence the multiple methods for measurement.

Sievo's PCF framework recognizes procurement contribution in three forms that are mutually exclusive, i.e. they should not be added to create one number that ought to be directly linked to the company's financial statements, though collectively exhaustive. These three forms as a whole represent the effect of procurement to financials and summing them could be a way to measure the Return On Procurement (ROP) investments.

While procurement savings are calculated the same way, having them sepa-rate in the PCF framework is a means to ensure that only EBITDA savings are being reconciled with the P&L for sake of P&L reconciliation.



II.

Defining Cost Avoidance

Procurement contributions from one-off purchases are real, however cost avoidance cannot be measured as a driver of performance improvement from one period to the other.

Nevertheless, it is important to recognize that without such contributions, the cost of these purchases could have been greater and hence have a true impact on performance.

To recognize such contributions, cost avoidance is often calculated in the following two ways:

Cost avoidance = cost from initial quotation
- cost from final quotation
or
Cost avoidance = budgeted expense – realized expense

A separate cost avoidance log should be kept in the same way as line item notes on financial statements are. This will ensure that procurement contin-ues to support generally large capex purchases that require their negotiation expertise and gets rewarded accordingly.

III.

Defining Procurement Savings

Unlike cost avoidance, procurement savings are measurable from one period to the other. As much might have happened in a period it is important to dissociate what was controlled by procurement and what was not. The concept of value drivers is the starting point to engage in this exercise.

The concept of value drivers

Procurement savings are the result of a number of actions that the function has taken to reduce costs. These take multiple forms, and are specific to cer-tain situations and certain categories. Actions can be taken by procurement alone but often are the result of the collaboration with other functions.

The output of these decisions, before being translated into savings, are called category strategies or sourcing strategies and the actions are called value drivers. While value drivers are specific to supply industries, they can be categorized in demand, process and supply side drivers, from which they can further be standardized.

Though most value drivers are directly or indirectly under the control of procurement, a number of value drivers are not controllable. Non-control-lable drivers are related to business volumes and mix, currency fluctuations and commodities market swings.

Measuring procurement savings therefore must isolate non-controllable drivers from controllable ones. The role of procurement should be nar-rowed down to price negotiation, and the drivers outside the control of procurement should also be isolated.

Normalization

Normalization is the process which isolates non-controllable value driv-ers from spend-development. The result from this normalization is that a comparable cost increase or decrease can be associated directly or indirectly to procurement.

A formula to isolate multiple drivers can be applied as follow:

Drivers	Formula
Volume	(Qty Year N – Qty Year N-1) x Price Year N-1
Currency	Spend Year N x (1 – (ExRate Year N-1/ExRate Year N))
Market	Price Year N-1 x ((Market Index Year N / Market Index Year N-1) – 1) x Qty Year N

After isolation, procurement savings are calculated the following way to unveil financial contribution from one period to the other:

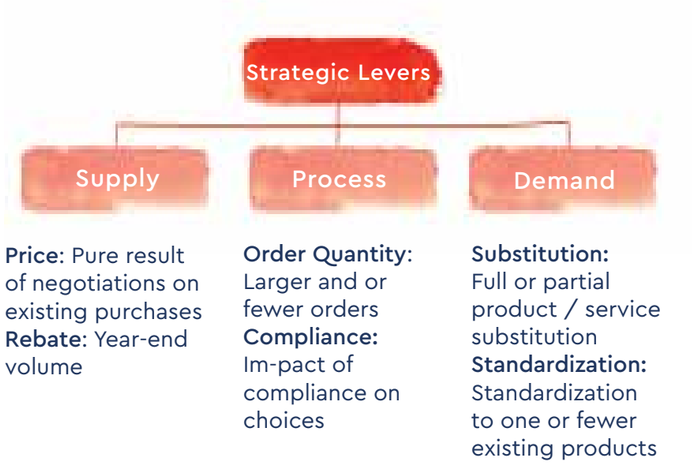
Procurement savings = Spend Year N – Spend Year N-1 – (Volume Impact + Currency Impact + Market Impact)

Strategic levers isolation

The normalization process is the first essential step to take in defining procurement savings. Leaving it there would provide an accurate view of pro-curement cost increase or decreases.

The step of strategic levers isolation aims at providing further clarity on the contribution of procurement and other functions. More specifically it aims at isolating the levers / drivers defined in the category or sourcing strategies.

While strategic lever isolation can further dissect performance for rewards purposes, the increased visibility ensures that strategic levers decided cross-functionally get implemented fully. By making them transparent, procurement governance can ensure full execution or act to correct unexpected behaviors. Typical strategic levers are represented in the picture on the next page.



The effect that substitution of inputs would have on procurement can be found by applying the following formula:

Substitution Impact = (Price Year N of New Product – Price Year N of Original Product) x (ExRate Year N-1/ExRate Year N) x Qty Year N of new product

IV.

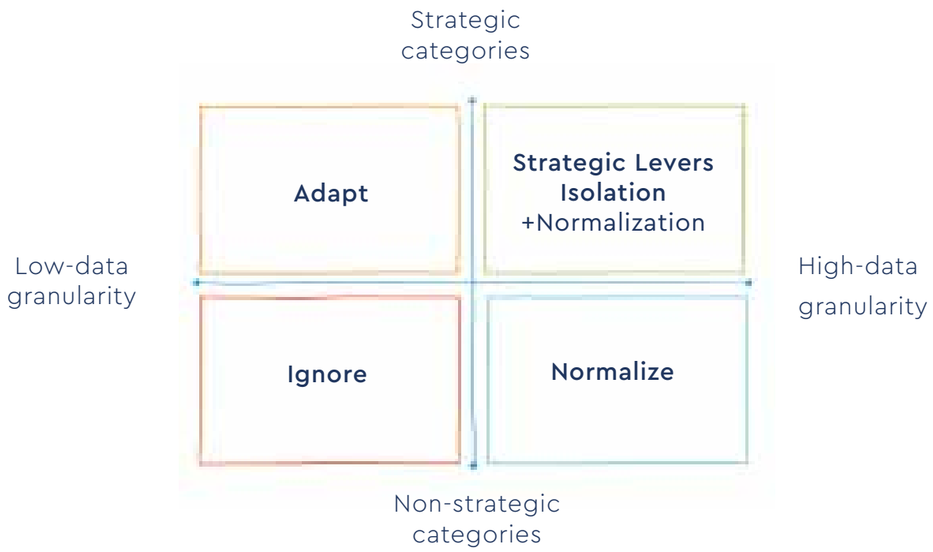
PCF and Procurement Savings in Practice

Normalization and strategic levers isolation are two key steps to unveil Procurement Contribution to Financials. But while normalization is a must-have step, strategic levers isolation is recommended for strategic categories.

Framework for measurement strategies

Applying procurement savings measurement in practice requires a segmentation of business areas that will allow focusing on certain categories over others. The following framework can be used to select the appropriate measurement strategy to spend categories.

Sievo's Framework for Savings Measurement Strategies



Experience has shown that strategic lever isolation and normalization are processes that are data intensive, especially when done at the transaction level. This need for data is represented on the X axis of the matrix above.

It is therefore recommended to apply the Normalization process to all non-strategic categories with data granularity, while strategic levers isolation ought to be applied in priority for strategic categories where data granular-ity exists.

For other strategic categories without data granularity a deeper assessment of data accessibility will help define the appropriate strategy.

Following spend without any specific normalization is the suggested ap-proach for non-strategic categories where data granularity does not exist.

When applicable, normalization and strategic isolation are processes that can be implemented for both direct and indirect categories of spend.

Direct purchase example

Consider an international company purchasing chemicals worth €23.1Mn in 2009 and which sees its total spend go up to €26.4Mn in 2010. By read-ing the profit and loss statement, finance deducts that spending increased by €3.3Mn.

The €3.3Mn cost increase ought first to be normalized to isolate all external non-controllable drivers that hide the actual contribution of procurement.

By assessing the spend further, one observes that market prices of the pur-chased commodity went up from a one year average of €18.0 per ton in 2009 to €20.0 per ton in 2010. One can also see that purchases were made at an average price of €21.0 per ton in 2009 and €22.0 per ton in 2010. Those purchases were actually made in USD at a USD:EUR rate that had risen from 0.7 in 2009 to 0.8 in 2010. Total quantities also increased from 1 100 tons in 2009 to 1 200 tons in 2010.

The normalization process led to the following results (rounded numbers):

Volume Impact = (Qty Year N- Qty Year N-1) x Price Year N-1
€2.1Mn = (1 200 – 1 100) x €21.0
Market Impact = Price Year N-1
x ((Market Index Year N/Market Index Year N-1) – 1) x Qty Year N
€2.8Mn = €21.0 x ((20/18) – 1) x 1 200
Currency Impact = Spend Year N x (1 – (ExRate Year N-1/Ex-Rate Year N))
€3.3Mn = €26.4Mn x (1 – (0.7/0.8))

After normalization, one can then deduct that procurement savings have actually been €4.9Mn for 2010.

Procurement Savings = P&L Delta 2010 vs. 2009 – Normalization
-€4.9Mn = €3.3Mn – (€2.1Mn + €2.8Mn + €3.3Mn)

First volumes must be isolated. This is done by determining a practical and acceptable value driver. In our case white collar headcounts are used as proxy. The number of headcounts has increased from 500 to 550 in the 2009 to 2010 period.

Volume Impact = (Qty Year N – Qty Year N-1) x Price Year N-1
€60k = (550 – 500) x (€0.6Mn/500)

Note that to calculate price, spend divided by headcounts is used as proxy.

The next step is to isolate the currency fluctuation impact as purchases are actually done in local currency and in our case in USD. The USD:EUR exchange rate for the period analyzed has moved up to 0.8 from 0.7 the year before.

Currency Impact = Spend Year N x (1 – (ExRate Year N-1/ExRate Year N))
€87.5k = €0.7Mn x (1 – (0.7/0.8))

After normalization one can deduce that the additional headcount led to an increase of €60k, currency fluctuations explain an additional increase of €87.5k while procurement savings have actually been €47.5k.

Procurement Savings = P&L Delta 2010 vs. 2009 – Normalization
-€47.5k = €100k – (€60k + €87.5k)

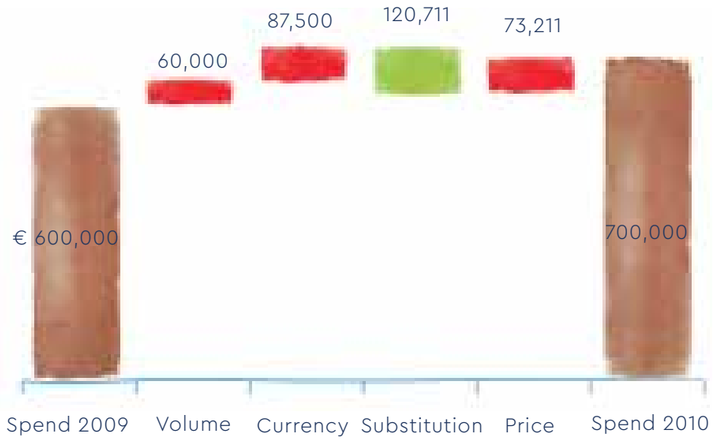
To the question of what has been driving the cost savings, procurement and IT decided to switch a percentage of volume from an incumbent firm to a new vendor. By analyzing the spend by supplier, one can see that for 2010 spend with the incumbent amounted to $0.43Mn versus $0.86Mn in 2009; spend with the new vendor reached $0.45Mn versus nothing the year before. Procurement and IT have also defined that the incumbent still serves 41 % of white-collar headcount.

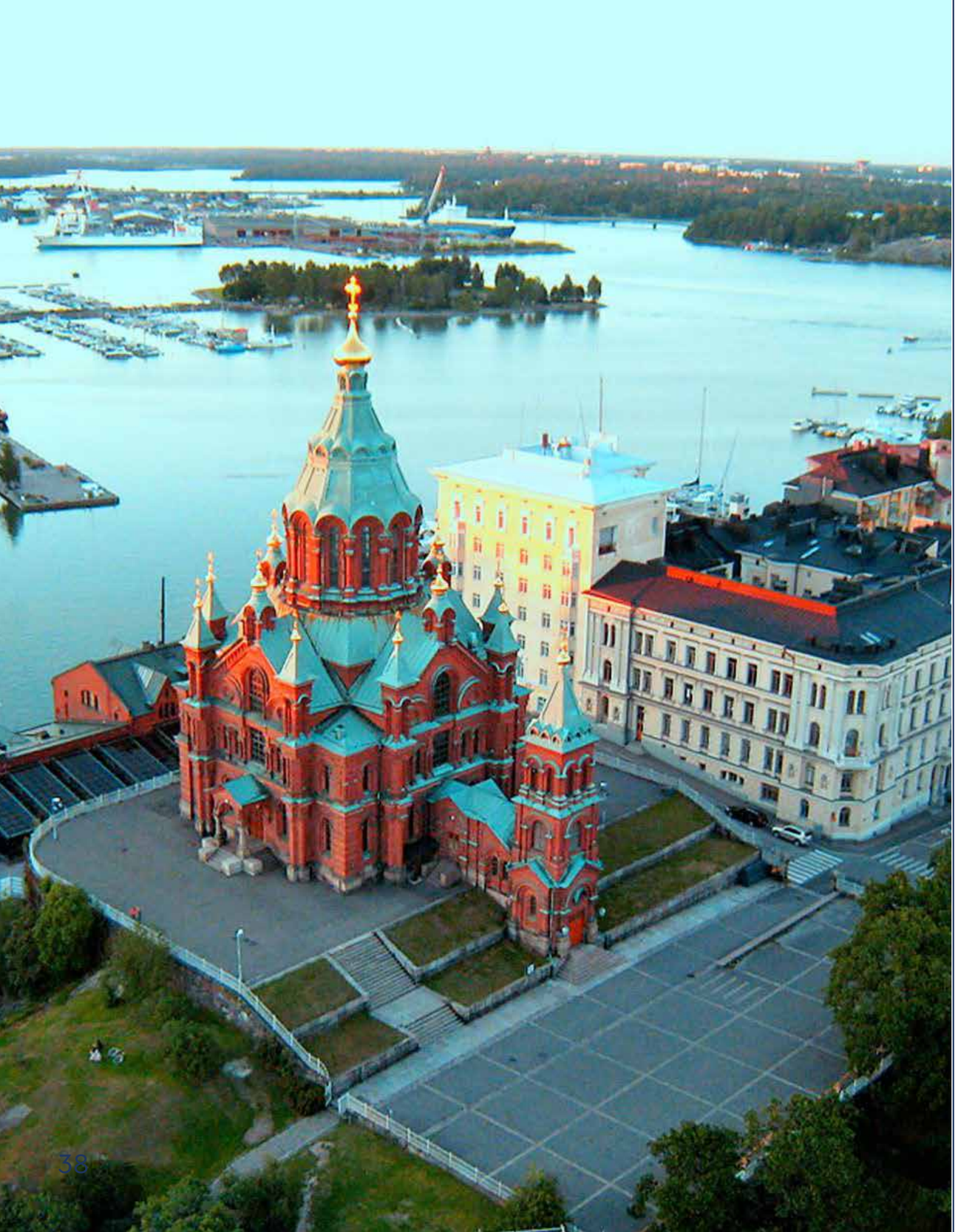
From this information on can deduce the impact of mix change.

Substitution Impact
= (Price Year N of New Product – Price Year N of Original Product)
x (ExRate Year N-1/ExRate Year N) x Qty Year N of new product
-€0.12Mn = (€0.36Mn/325 – €0.34Mn/225) x (0.7/0.8) x 325

In other words, the implemented substitution strategy generated a savings of €0.12Mn, suggesting that the volume that the incumbent is still provid-ing has led to a cost increase of €73k.

Telecom PCF Example





V.

Conclusion

Sievo's PCF model has been defined as a tool for the procurement and finance community. It is the result of decades of practical experience at the intersection of procurement, finance and IT. Built on rigorous yet simple mathematical and financial principles, the PCF aims at becoming the common language between finance and procurement.

Taking PCF into practice requires a number of enablers:

- **Technology**: the technology shall allow the isolation of value drivers and manage complex data sets and calculations
- **Cultures**: a change in mindset ought to be anchored within finance and procurement alike
- **Skills**: financial and analytical skills are a prerequisite to work with PCF and interpret the results for actions

As pioneer in Procurement Performance Management Sievo's software is the technology that automates PCF across organizations. Designed for that purpose, Sievo's application analyzes past purchases, predicts future spend and measures performance based off the foundation of the PCF concept across a number of organizational, time and category dimensions.

For further reading and information, please consult Sievo at sievo.com

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About Sievo

Sievo is a leading procurement analytics SaaS solution company that provides spend visibility, but also goes way beyond that. We help our clients identify opportunities, translate these opportunities into projects, embed created value into budgets and ensure that savings truly hit the bottom line. We speak the language of procurement and also translate numbers into the financial view.

Our solution is used by thousands of users in best-in-class procurement organizations, such as Deutsche Telekom, ISS and Kellogg's. With our clients, we don't stop at backward-looking reporting but deliver more by creating forward-looking forecasts and comprehensive analytics. We combine internal information with external data sources. With Sievo, human input and machine learning technologies are integrated together. In short, we translate procurement data into dollars.

Since our founding in 2003, we have experienced rapid, profitable and self-financed growth. Currently we employ more than 100 professionals and have offices in Europe and US.

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