

Optimizing Purchasing Management of Non-Product-Related Goods and Services

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Abstract

Until recently, purchasing was very manufacturing oriented with an emphasis on production buying. The purchasing of non-production goods and services has only gained limited attention from management and researchers. Because of this undervaluation there is often no clear and direct insight in the size and content of the purchasing volume of non-production items and services. It is often difficult for most managers to identify the answers to basic questions like: how much is spent?; on what?; by whom?; with what frequency?.

In many companies non-production goods and services are purchased without the involvement of the purchasing department. This is not necessarily bad, but it requires management to control these purchases in a different way. For this reason we analyse the current methods that are used for controlling the purchasing of NPR goods and services.

The paper starts with a description of the importance of effective purchasing and the current developments and changes that affect purchasing organization and control. Then we focus on NPR purchases, a likely candidate for being done outside of the Purchasing Department. Then we describe the current methods used for managing purchasing outside of the Purchasing Department and their shortcomings. We conclude that it is an imperative demand for new methods in controlling purchasing of non-product-related goods and services.

Key words: purchasing management, optimization, control.

J.E.L. Classification: L84, L21

1. Introduction

In many organizations, a large part of purchasing expenditure is in non-production goods and services. These ‘nontraditional’ (non-product related) areas, such as insurance, utilities, consultancy, travel and advertising, are also likely to be purchased outside of the Purchasing Department and without the benefit of professional buying practice and skills. The value for money obtained by a more effective purchasing practice on these expenditures represents a major opportunity.

It appears that during the past few years purchasing has begun to play an ever more important role in the strategy of the firm (Ellram, 1994; Carter, 1996; Weele, 1996). In order to survive, managers have begun to rethink their competitive priorities and their

value chain. Increasing numbers of organizations have recognized that effective purchasing holds the potential to transform their competitive performance for the better. The importance attached to effective purchasing has increased not only because organizations realize that one dollar reduction in purchasing spending equals a one dollar increase in profit (whereas one dollar in sales might only lead to a 10 cents increase in profit) but also because of the tangible success of high visibility organizations as Toyota, Daimler Benz, Siemens, Philips, etc who have each developed effective purchasing and supply chain management as a core competence.

The supposed increased importance of the purchasing function is most notably reflected in the growing share of turnover organizations spend on paying their suppliers for delivering all kinds of products and services. The purchase value of goods and services contributes substantially to a company's turnover.

The importance of the purchasing function is not limited to the financial impact on the organization. The significance of the purchasing function can be related to the growing need for companies to simultaneously meet market demands such as quality, price, flexibility and the level of innovation (Wijnstra, 1997). In order to meet these demands as well as to achieve cost reduction, companies have been forced to apply a more integrated approach in quality management and logistics.

Given the significance of purchasing outlined above, it can be concluded that purchasing has an important effect on the profitability of an organization and that it forms an important (potential) source of competitive advantage for many companies. Therefore, there is too much 'at stake' for the company's purchasing activities not to be well equipped and professionally organized, and not to form an integrated part of the organization.

2. Literature review

In recent years purchasing management has changed dramatically. Most of the changes from the business environment have influenced the way the Purchasing Department must operate.

The scope of the purchasing function is far wider than the activities of the Purchasing Department in most companies. Not only the purchasing people do the purchasing work; other employees in an organization perform activities in this field, too. For example, the people who do the activities like administration, inspection of the incoming goods, etc. So it is clear that the spreading of the purchasing function also leads to an increasing number of people being involved in purchasing activities.

These developments one way or another all add to the fact that goods and services are bought without intervention of the Purchasing Department (see examples in Table 1). Apart from the Purchasing Department, therefore, many other departments within the company are actively engaged in buying goods and services.

In a study in 1995 the Center for Advanced Purchasing Studies (CAPS) found that from the total of \$ 140.3 billion purchased by the 116 organizations, only 41 percent was spent by the Purchasing Department; 59 percent was spent by some department /individual outside of the Purchasing Department.

The main reasons for purchasing outside of the purchasing department to increase are:

- The Purchasing Department itself wants to get rid of all ordering activities and to spend more time on value adding activities such as tactical procurement;
- General management is rapidly recognizing the financial impact of purchasing and therefore wants to manage this external spend themselves, especially in the lights of being responsible for their departmental results;
- The advent of E-commerce and other information technologies, such as Internet enables all users to order and buy things through their computer;
- Finally most people consider purchasing as a nice activity which they prefer to perform themselves.

Table 1: Examples of items purchased outside of the Purchasing Department

| Type of purchasing item | Purchased by |
|-----------------------------|--------------------------------|
| Computers and software | Computer/Automation Department |
| Insurance | Administration |
| Advertising | Sales, marketing |
| Temporary labor | Personnel department |
| Car lease | Administration |
| Travel | Personnel department |
| Accountancy and consultancy | Management |

Source: adapted after Weele, A. J. van, (2010);

The role of the Purchasing Department in the purchasing process varies from company to company and from situation to situation. In general, the Purchasing Department’s involvement is highest in purchasing of raw materials, special and standard production items and MRO supplies. The involvement of the Purchasing Department is smaller or absent in the purchase of non-product related (nontraditional) goods and services, such as:

- Capital equipment (vehicles, lathes, etc);
- Services, which are all those purchases that have a high content of personal input (health care plans, insurance, advertising, legal assistance, and telecommunications);
- Resale items (e.g. the tires sold in a petroleum firm service station).

Studies indicate that the role of the Purchasing Department is much smaller in the purchase of both traditional and nontraditional (non-product related) goods and services than commonly believed. For example, the Center for Advanced Purchasing Studies (CAPS) in a study in 1993 (“CEOs’/Presidents’ Perceptions and Expectation of the Purchasing Function”) found that the Purchasing Department in many firms did not participate fully in the purchase of the traditional items (e.g. the purchasing department had full input to the purchase of raw materials and MRO supplies, in only about two-thirds of the firms). They also reported that in a surprisingly large percentage of firms, the Purchasing Department had no input to the purchase of nontraditional goods and services (e.g. in 39% of the firms, there was no input to the purchase of services, and no input in 55% of the firms to the purchase of utilities).

Similarly, the Bureau of the Census of U.S in the “Annual Survey of Manufacture”(1991) estimated that in the manufacturing sector only 57% of sales was spent on the purchase of materials and capital equipment while 24% of sales was spent on services as accounting, advertising, legal services, and utilities. The dollar amounts spent on nontraditional goods and services are very large (144 billion \$), and *who* really does the purchasing is an unsolved question.

Telgen and de Boer (1995) present a number of characteristics of non-product related items and services which may contribute to the fact that they are purchased outside of the Purchasing Department:

- wide range of items and services which are often coupled with an even larger numbers of suppliers;
- relative high frequency of initial purchasing activities;
- high level of internal end-user involvement, especially in the initial steps of the purchasing process;
- reciprocity – the general and supportive character of many non-product related items and services implies a relatively high frequency of reciprocal relationships between organizations.

Also, purchasing of non-production items and services is not seen by managers as a necessity, compared to the purchasing of items and services for the primary process. As a consequence of this undervaluation, structural attention and management of purchasing of non-production items and services is not considered as a means for improving effectiveness and reducing expenditures. Because of the lack of clear and direct insight in the size and contents of the purchasing volume of non-production items and services, managers are missing opportunities for adding value to their organizations.

3. Theoretical background

Because of the proliferation of purchasing activities throughout the organization, the management of these activities is a very difficult task. At the same time it is a very important task, since purchasing spends generally represents about 70% of turnover in industrial companies and 40% in public organizations.

As we have seen earlier in many organizations non-product related goods and services are purchased without the involvement of the Purchasing Department. This is not necessary bad but it requires management to control these purchases in order to make sure the organization’s interest is well served. Two approaches can be used in performing the control phase of purchasing management: problem prevention (pre-action control) where possible, followed with a monitoring system that detects problems (post-action control) that slip through the prevention net. With regards to control of the purchasing performance the following methods are used in practice:

A. Pre-action control:

1. Budgeting - In the purchasing area several budgets may be used e.g. per purchasing package (materials, MRO-items, capital investments) and/or per department.

2. Limited buyer authority. The manager can control expenditures by requiring larger expenditures to be signed by a purchasing manager.

B. Post-action control:

3. Monitoring purchasing cost savings - These refer to the extent to which the purchasing function is able to lower total costs of purchased materials.

4. Ratios and indices

5. Purchasing reports - Information on how the purchasing function operates may be regularly reported to top-management.

6. Audit - The purchasing audit is a review-procedure to ensure that proper procedures relative to purchasing and management principles have been applied.

All of these methods do have significant shortcomings in practice (Weele, 1984); especially in so far as they are applied to the purchasing activities outside of the purchasing department. For controlling the purchasing performance with these methods most methods are inadequate.

- For example, the budgets can indicate the maximum spending but they can't control the quality of purchasing: what are we buying? ; at what price? ; from which supplier?. Budgeting in purchasing in most cases only includes the direct or production materials and departmental expenses, whereas indirect materials and other items remain out of focus.
- Most of the purchasing ratios and indices serve primarily as indicators or warning-signals, but it is not clear what to do with them.
- A problem with purchasing reports is that these usually do not explain why certain problems occur.
- The purchasing audits are little used in most of the companies because of the time and costs involved. If they are used the translation of their results into management control is still very difficult.

Also, for all of these approaches to be manageable we have to create within the organization appropriate structures and to provide appropriate training, supervisory guidance and motivation for personnel in order to be able to do it properly.

4. There is a need for new methods and approaches for managing purchasing outside of the purchasing department

As we have seen earlier the current control methods have significant shortcomings and they are not working properly when they are applied to purchasing outside of the Purchasing Department. Therefore there is a clear need for new methods and approaches for managing purchasing outside of the Purchasing Department.

In developing new tools and methods for controlling purchasing outside of the Purchasing Department we have to take into account the fact that there are different types of purchases in an organization:

- Raw materials
- Non-product related purchases (NPR)
- Semi Manufactured Products
- Components

- Finished Products
- Maintenance, Repair and Operating Supplies (MRO)
- External services
- Capital equipment.

For example we might want to use different methods in controlling the purchase of new capital equipment for production and in controlling the purchasing of office supplies. The acquisition of new capital equipment represents a huge investment and cannot be undone if post-action control indicates so. Whereas the purchase of office supplies can easily be directed through post-action control since there is a new shipment needed almost continuously and there is not much money involved in one shipment.

As a consequence of the differences between the types of purchases we might have to focus on a subset of these types. The most interesting then will probably be the ones for which “purchasing outside of the purchasing department“ occurs most frequently. As we have seen these types of purchases are likely non-product related purchases, capital equipment, services.

In developing tools for managing purchasing outside of the Purchasing Department we also have to take into account the fact that for some activities it may be good or even desirable that they are performed outside of the Purchasing Department. Some of the typical daily operational activities (ordering, incoming items control, administration) can be performed successfully outside of the Purchasing Department. The Purchasing Department might still want to provide tools, methods and training to help (teach) people outside of the purchasing department to buy in a correct way, but there is no reason why they should be directly involved.

Activities regarding initial and tactical purchasing (setting up long term contracts, preparing and developing purchase order specifications, selection and contracting of suppliers in general and programs aimed at supply-base reduction in particular, etc) usually belong to the responsibility of the Purchasing Department. Some disadvantages may arise from performing these activities outside of the Purchasing Department :

- lack of economies of scale ;
- no uniform attitude towards suppliers ;
- the impossibility of a tighter control on overall purchases performed in a company ;
- probably different commercial purchasing conditions for different business units (departments) ;

Conclusions

The problem of managing purchasing outside of the Purchasing Department can be approached from various points of view, such as: Purchasing Department, buyers, managers, internal customers, etc. We approach the problem from the management point of view and we are trying to discover how managers can deal with the proliferation of non-product related purchasing activities throughout the organization and how they can control them.

We choose the management point of view because control is a major responsibility of management, and a large portion of the organizational information processing pertains to control. Purchasing control can be used by managers as an instrument for supporting and managing the entire purchasing function. In particular, it can contribute in two ways:

1. Providing quantitative insight in purchasing ‘flows’ through the organization. Basically, it provides answers to questions like:
 - how much is spent on product related items and non-product related goods and services?
 - how much do different departments buy?
 - how many active suppliers do we have?
2. Based on the quantitative data, identifying and detecting the apparent ‘weak spots’ in the purchasing function. Purchasing control is on the outlook for ‘suspicious’ situations, e.g. an extremely large number of suppliers for a minor non-product related commodity. Further investigations are always necessary to assess whether the suspicion was justified.

That is why we have to develop new or better tools to support (general) management in ‘controlling’ the purchasing activities, whether they are performed within a purchasing department or not. Managers have to be aware of what is going on in the company (who buys what?; where?; with what frequency?) and based on this information they have to decide how is best to organize and control the non-product related purchasing in order to be more efficient and to increase profits.

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