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Targeting procurement: Why CFOs should take direct aim at indirect spend

The procurement function has not lacked for attention in recent years. Even before the pandemic—with digitization experiencing a notable acceleration[1]—traditional models of procurement were being upended by data-driven approaches to unlock value. Now, with cost reduction remaining high on their list of priorities (see Deloitte's 2021 Global Chief Procurement Officer Survey), many chief procurement officers (CPOs) are feeling the pressure of ongoing efforts to boost efficiency.

Typically, CPOs are charged with delivering year-over-year cost reductions of three percent or more. But the toughest part of that challenge often lies less in hitting the target and more in navigating the methodology and trade-off agenda: Do we prefer near-term benefits over potentially larger longer-term ones—achieved by transforming what and how we buy? How do we measure benefits? Most important, how are savings treated (reinvested or banked), and who makes that decision?

As rigorous as the process may be, CPOs and CFOs may still be inadvertently overlooking a rich source of potential savings.

How so? Historically, CFOs and CPOs have focused on improving sourcing by consolidating the base of their biggest-dollar suppliers, allocating their best resources toward high-value contracts for direct materials categories, such as raw materials or finished goods, that directly contribute to driving growth, profitability, and competitive advantage. But not to be overlooked is the potential of maximizing the value in the less-visible indirect categories, such as travel, logistics, and information technology, as well as maintenance, repair, and operations. Even large-scale construction and capital projects contain great potential for the more efficient allocation of funds. Such indirect goods and services can run on the order of 10% of revenue in some industries, and even more in others.

Put simply, the difference between direct and indirect spend is that while the former represents the cost of *doing business*, the latter incorporates the cost of *being in business*. And while one is concentrated and controlled, the other often requires changing behaviors across the organization to drive compliance to preferred suppliers and negotiated commercial agreements.

Despite the ongoing quest many CFOs have undertaken to turn the procurement function from a cost center into a source of value, optimizing indirect spend all too often is lower on the priority list. In this edition of *CFO Insights*, we'll analyze indirect procurement and ask: How can CFOs and CPOs collaborate to gain control over such spending? Who should be accountable for bringing robust management to it? And why is this a propitious time for CFOs to take on this challenge?

Sweating the smaller stuff

Gaining visibility into indirect spend represents a long-term undertaking. When tracking direct suppliers, for instance, many companies have achieved visibility into their Tier 1 group, but not beyond. In fact, results from Deloitte's 2021 Global CPO survey show that approximately 70% of respondents felt they had good visibility on the risks that existed in their direct Tier 1 suppliers.[2] But just 15% claimed they had visibility into Tier 2 and beyond.

The COVID-19 pandemic, however, drew attention to the need for CPOs to gain a surer grasp on their end-to-end supplier network, including the risks beyond direct suppliers. To gain that efficiency, CFOs should consider working with CPOs to not only wring savings from direct suppliers, but also install better oversight over indirect spend. That is no small feat. With indirect spend, strategy and processes tend to remain less sophisticated; the focus is on achieving cost reductions by obtaining the lowest price possible; and relationships with suppliers often lean toward the transactional.

There's also the problem that indirect spend may be decentralized and spread among many internal shareholders, making cost reduction opportunities difficult to identify. The sheer number of suppliers and categories involved can be overwhelming, as can the diversity of contracts that may be ad hoc agreements or cover intermittent services. In addition, spending in categories, such as airfares and hotels, is difficult to accurately allocate to a single cost center.

Given its multitude of internal stakeholders, the responsibility for indirect spend typically falls to functional leaders, who may not have expertise in procurement. In response, the procurement organization might need to cultivate more nuanced relationships with those non-procurement internal stakeholders so it can evaluate, and potentially revisit, existing supplier contracts. In addition, CPOs—17% of whom report directly to CFOs, according to Deloitte's *CFO Signals*™ survey for the first quarter of 2021[3]—may want to consider the following actions to help bring indirect procurement into focus:

- **Separate indirect spend from direct spend**. In some industries, such as retail, it is increasingly common to relocate indirect suppliers into a separate group, with its numbers rolling up to the CFO. Doing so can enable both the CFO and CPO to bring added focus as to how to derive additional value from indirect spend. Is there enough volume in some categories to gain leverage over pricing? How should services, which comprise a large and growing portion of indirect spend at many companies, be managed? Creating an indirect-procurement unit clarifies accountability and assigns procurement professionals to look for different ways to control costs. The resulting savings might more than offset any SG&A costs associated with establishing the new unit.

- **Install leadership over indirect spending**. It's understandable why many CPOs typically focus on the higher-margin direct suppliers that are core to a company's products. Given that focus and the fact that indirect purchasing requires bigger shifts in ways of working across a wider range of categories, installing a head of indirect procurement under the CFO makes sense. It enables collaboration between budget setting and procurement planning and allows the CFO to delegate diligent management to someone who appreciates the subtleties in managing different stakeholders.
- **Hire or train relationship managers**. It's easy to imagine that marketing executives, for example, might not welcome a procurement professional offering suggestions that they feel could harm their relationship with their current creative agency. But with ongoing dialogue, functional owners, such as CMOs and CIOs, may begin to see what they have to gain by sharing information about key contracts, even though their own performance may be judged on retaining customers. To build such partnerships, procurement leaders need to tread lightly to avoid coming across as if they are telling their peers how to do their jobs.
- **Define the CFO's role in cost reduction**. Reducing costs doesn't automatically translate into saving money. There's always the risk, in fact, that $10 million that departed one budget will simply migrate to another. That's why CFOs need to support the monitoring

of contracts and overall commercial compliance and ensure that each team has properly recorded its planned and delivered impacts in their financial statements and budgets. It's also up to the CFO to decide how to treat the savings (i.e., whether to bank or reinvest, as opposed to letting functional, regional, or divisional leaders decide how to appropriate the dollars).

- **Apply technology to ensure appropriate visibility into spend and improve processes**. Because of the impact of compliance on outcomes, indirect procurement should be outfitted with technology that can proactively analyze, channel, and manage spend—pinpointing and reducing both "maverick" spending and savings leakage—thereby improving visibility and ensuring adherence to policies. Such technology can also improve productivity, especially in areas such as accounts payable.

Direct questioning

In the course of centralizing indirect spending, CFOs will likely spot opportunities to add value by lowering total cost of ownership. For example, they may find it worthwhile to standardize all cost-related policies. But CFOs can't apply more strategic decision-making to indirect spending without having an account of its current scope.

Getting those details means asking the CPO for a few particulars, including the following:

- **Which suppliers are we spending money with, on what, by whom, and how much?** Building an infrastructure around indirect spending starts with an inventory of that spend. But CPOs often preside over multiple ERP systems that may include the same suppliers under different names. M&A activity within the supply base may not have been recorded. And specifics about purchases, derived from work orders and invoices, may (or may not) have been scanned into a central repository. Still, however the information can be collected, CFOs need it to get a full picture of how many deals are poorly negotiated—if at all—in categories that are considered low value and low risk.

- **How much visibility do we have into indirect spend?** Many CFOs don't have a complete line of sight into their indirect spend because so much of it has been managed by functional leaders. Logistics groups sign contracts with transportation carriers; marketing cuts deals with creative agencies. Some companies may have procure-to-pay systems to cut down on manual processes, but may lack automation that can help with strategic sourcing[4] and tying contracted pricing to purchases. By exploring a variety of technology options, companies can identify systems that centralize their approved suppliers or enable employees to log in and make purchases through a catalog.

- **Is the business getting the best value for its indirect spend?** Comparing year-over-year numbers may help CFOs prioritize which suppliers or categories to target—assuming such data isn't stuck in a silo or trapped on a spreadsheet. Once retrieved, that information can enable volume purchasing, with deeper discounts and better terms. Over time, indirect procurement may develop its own metrics for measuring and tracking the performance of its big suppliers.

- **What's the best way to account for the savings driven out of indirect spending?** Procurement leaders want to be recognized for the value they deliver. But making sure those wins are taken to the bottom line—or reinvested appropriately—can be complicated, given that indirect savings aren't always clearly linked to a single cost center. With direct materials, for example, the function can be recognized for the value delivered by comparing this year's paid price to last year's and subtracting any market price differential. But much indirect spending isn't repeatable—or the last paid price may not be in the system. Management needs to make decisions about how to report any savings out to the business, which may mean reducing every cost center's budget by a set percentage.

- **Does the enterprise employ the necessary technical expertise?** The 2021 Global CPO survey found that high-performing procurement functions were investing in developing agility. For CPOs, that translates into leveraging a hybrid model of service delivery. In the case of indirect procurement, leaders should make sure to have the flexibility to choose whichever workforce option will deliver value: developing talent, bringing in employees from other functions either within, or external to, procurement, or outsourcing to service providers. The key is to stay focused on building capabilities that will deliver desired outcomes.

Figure 1. Changing procurement priorities

Over the next 12 months, how much of a priority are each of the following business strategies?

Note: The graph follows Likert-scale weighted score.

Source: Deloitte Global CPO Survey 2021, Deloitte Consulting LLP

Although its spend may not always be strategic or core, indirect procurement's transformation can have a direct impact on the organization's bottom line.

Targeting a new source of savings

As their companies emerge from the pandemic, CPOs may feel added pressure to boost efficiency through leveraging data, implementing digitization, and collaborating with suppliers. Those latter efforts, however, should not be limited to direct suppliers.

Although its spend may not always be strategic or core, indirect procurement's transformation can have a direct impact on the organization's bottom line. The duty will fall to CFOs to oversee the change-management aspects of the shift. They'll likely have to ensure the smooth introduction of new tools and technology, as well as balance the risks associated with reorganizing indirect procurement. As chief resource allocators, CFOs can direct funds toward the effort, signaling to CPOs and others involved that the changeover remains a top priority.

Throughout the process, CFOs and CPOs should make an effort to stay closely aligned in terms of their goals and objectives. There will likely be unknowns to manage, and policies and procedures may be leading to savings leakage. But CFOs, many of whom have led their companies through an unprecedented crisis, are better prepared than ever to perform diagnostics, maintain communication, and prevent the indirect procurement function from veering away from the company's strategic goals. Such hard-earned skills, honed amid chaos, can play a valuable role in the procurement function.

CFO Signals™: For many companies, supply chain snarls prove costly

Indirect procurement practitioners don't tend to focus on cultivating enduring, collaborative relationships with their multitude of suppliers, but they are keenly aware that any bottlenecks could tarnish the bottom line. Clearly, the COVID-19 pandemic reinforced the message that supply chain disruptions can be costly.

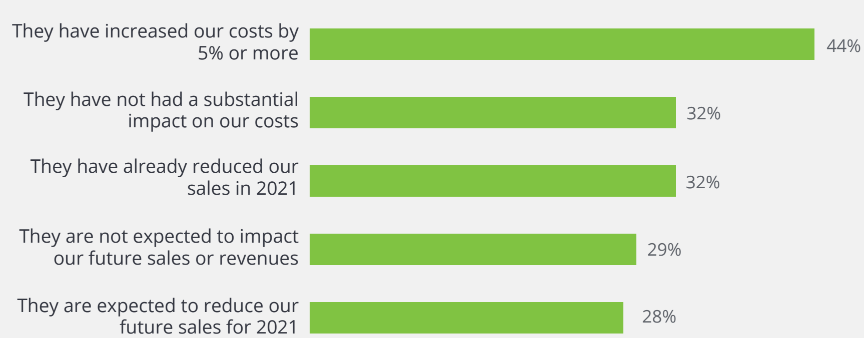
In Deloitte's North American ***CFO Signals***™ survey for the third-quarter of 2021, 44% of CFOs reported that supply chain shortages or delays have increased their companies' costs by five percent or more. Almost one-third (32%), reported that their 2021 sales have dropped as a result, while 28% expect such supply chain issues to inflict more damage on sales this year. By contrast, 32% of CFOs said that supply chain shortages or delays have not had a substantial impact on their costs, and 29% noted they do not expect future sales or revenue this year to be affected.

The survey, conducted August 2-14, 2021 drew responses from 96 CFOs, the vast majority (85%) from companies with more than $1 billion in annual revenue.

Looking ahead three years, 69% of respondents predicted their supply chains would include a wider diversity of sources, while 23% foresaw greater vertical integration of their supply chains. In the Q4 2020 *CFO Signals* survey, 49% of respondents agreed that their supply chains would be more diversified in 2021 than pre-pandemic.

CFOs also expected to increase or decrease sourcing from various regions, with North America expected to see more increases than other regions. In fact, 39% of CFOs said sourcing from North America will grow, while 22% expect sourcing from Asia other than China to expand. In addition, 13% of CFOs said their supply chains would increase sourcing from Europe, 9% from China, and 6% from South America. Nearly one-third of CFOs (32%) indicated their sourcing from China would decrease, while 11% expect to reduce their sourcing from Asia outside of China. A smaller percentage of CFOs expect decreases in their supply sources from South America (9%) and Europe (8%).

Figure 2. Supply chain hits and misses
*What effect have recent supply chain shortages or delays had on your company this year? (Select all that apply) (N=90)**



*90 (94%) of 96 respondents answered.

Source: *CFO Signals*™, Q3 2021, CFO Program, Deloitte LLP

End notes

1 "Smart sensors and supply chain innovation," Deloitte Development LLC, 2018.

2 Deloitte's 2021 Global Chief Procurement Officer Survey: Using agility to address changing chief procurement officer priorities, Supply Management and Digital Procurement practice, Deloitte Consulting LLP.

3 *CFO Signals*: Q1 2021, CFO Program, Deloitte LLP.

4 The Future of Procurement in the Age of Digital Supply Networks, Deloitte Development LLC, 2017.

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