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Straight to the Bottom Line®

An Executive's Roadmap to World Class Supply Management

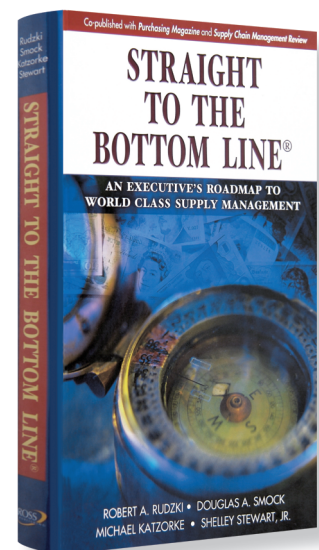
THE SUMMARY IN BRIEF

First, purchasing and procurement moved from a simple negotiation practice to a strategic interface with external resources. Next, procurement moved from simple procurement (dealing with discounts) to supply management (dealing with the optimization of supplier relationships). *Straight to the Bottom Line* highlights these new, valuable perspectives and enables senior corporate executives to turn the enormous top-line and bottom-line potential of supply chain and procurement into reality. By following the straightforward principles of *Straight to the Bottom Line*, senior corporate executives can improve performance quarter-to-quarter and year-to-year.

In addition, the authors explain the contributions that supply management can make to corporate success, and how managers and executives can achieve these goals. They also present a step-by-step roadmap for senior executives on how to implement a supply management transformation that quickly drives significant savings to the bottom line.

IN THIS SUMMARY, YOU WILL LEARN:

- How to optimize performance by using rapidly improving software for supplier negotiations, spend analysis and contract management.
- How modern supply management can improve ROIC.
- How to address the problems and concerns of executives, procurement managers and their teams.
- How to increase shareholder value through better procurement/supply base management.
- How to transform your purchasing department into a strategic supply management operation that adds value up and down the supply chain.



by Robert A. Rudzki,
Douglas A. Smock,
Michael Katzorke and
Shelley Stewart Jr.

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THE COMPLETE SUMMARY: STRAIGHT TO THE BOTTOM LINE®

by Robert A. Rudzki, Douglas A. Smock, Michael Katzorke and Shelley Stewart Jr.

The authors: Robert A. Rudzki is president of Greybeard Advisors LLC. He is the author of *Beat the Odds: Avoid Corporate Death and Build a Resilient Enterprise*.

Douglas A. Smock is editorial director of GlobalCPO.com, an online source of procurement analysis and best practices. He was editor in chief of *Purchasing* magazine.

Mike Katzorke is vice president of supply chain management with Smiths Aerospace. He was senior vice president of supply chain management at Cessna Aircraft Co.

Shelley Stewart Jr. is senior vice president of operational excellence and chief procurement officer at Tyco, where he leads supply chain initiatives across the company.

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Executive Assessment: Pre-Transformation

In smart companies today, purchasing is a part of the holistic corporate function and strategy and is not treated as a stand-alone function. Nor are engineering, manufacturing, logistics and sales. They are all marshaled to address a company's cost structure — as well as its top-line growth.

Smart companies tap the power of their supply base, not only for best-in-class technological innovation but also for supply chain improvements that can dramatically improve return on invested capital (ROIC) through actions to improve revenues, reduce costs and improve the capital intensity of the business. A key driver for improving shareholder value is to ensure that the ROIC exceeds the company's cost of capital. Modern supply management can improve ROIC in many ways, including actions to improve margins and actions to improve asset utilization.

The reality in Western business is that only a few companies have both assigned a strategic role to purchasing and sustained that role over time. Other companies have assigned a strategic role to purchasing for a period of time, or until a new corporate priority (or fad) moves into the top slot. Most companies have not yet fully realized the enormous opportunity this purchasing offers.

The Tools

For the most part, the tools for success are available to everyone.

The big challenge seems to be internal to the organization itself. Key executive-office issues are a lack of understanding of the opportunity presented by improved supply-side performance; lack of active support for purchasing; poor choice of leader for the purchasing function; incorrect reporting relationship between the chief procurement officer and the executive suite; a lack of alignment between corporate, financial and purchasing objectives; and, most important, a weak or totally lacking mandate.

The purchasing issues include problems created when the top person is not a true leader, skill sets are missing or deficient, purchasing objectives are not shared with other key stakeholder departments (such as operations or engineering), and best practices are not understood or embraced.

Corporate Profitability

Purchasing, or more broadly supply chain management, can play a significant role in boosting corporate profitability.

Organizations that have achieved significant performance breakthroughs have first come to understand and believe that purchasing can have an enormous impact on a company's total performance. And then they have fundamentally redefined the role of purchasing in their company. That new role is characterized by the following:

- Purchasing is an ongoing corporate priority.
- Reports to a senior executive officer.



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service@summary.com

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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor in Chief; Andrew Clancy, Senior Editor; Christine Wright, Senior Graphic Designer; Chris Lauer, Contributing Editor

- Has a clear, strong mandate to effect transformation and change in the organization's supply chain and procurement practices and to impact return on investment directly.
- Has a clear mandate to manage all supplier discussions, negotiations and selections and to control all external spending.
- Has objectives that are part of the corporate priorities.
- Leads cross-functional teams that cross all internal "boundaries" and can itself contribute to culture improvement within an organization.
- Can serve as the "eyes and ears" for the organization, due to purchasing's unique position of interacting with many suppliers from many industries; in this role, purchasing can play a key role in identifying competitive opportunities and threats.
- Leads the effort to tap the resources and competencies of current and prospective suppliers.

The Benefits

The benefits of purchasing playing that new role — as demonstrated by leading organizations — are nothing short of competitive advantage and outstanding business performance improvement in the following areas: cost structure, organizational discipline, return on assets, asset recovery, risk management, compliance and governance, customer satisfaction, supply chain efficiencies and cycle times, product development cycle times, reduced capital investments, top-line revenue growth, and increased stockholder value.

Once you have committed to the concept that supply-side management is a critical component of corporate success, the most important steps are:

1. Establish clear and measurable goals.
2. Make sure that purchasing — or more broadly supply chain management — is appropriately aligned in the company.
3. Make correct corporate structure part and parcel of the process (centralized, decentralized or hybrid).
4. Put a leader in place who can implement the change you desire.
5. Ensure that you have the right tools and training in place.
6. Last, measure performance on a regular basis. ●

An Executive Roadmap

The business world is a battle of global supply chains. One is pitted against the other. Your entire

supply chain must be aligned with appropriate goals and measurements.

To start, goals for supply management must meet the normal management accepted wisdom. They must be SMART: specific, measurable, attainable, relevant and time sensitive. Add an extra S for stretch — attainable, but with a very strong effort.

Second, you must assess where you stand relative to your competitors and best-in-class standards, regardless of the business you are in. Best-in-class companies achieve significant cost and quality advantages over their competitors.

The Endgame

The endgame, of course, is cost performance and predictable, sustainable returns that please your shareholders. But there are many ways to achieve those goals. Most chief purchasing officers work to meet annual cost targets, typically reductions of 3 to 4 percent. The IBM purchasing group is expected to report 5 percent better than best-in-class net of all price changes. That is an ambitious, unambiguous challenge. Make your purchasing people stretch.

Experts recommend a three- to five-year overall cost reduction target that is mutually owned by purchasing and other stakeholders, such as manufacturing, engineering, R&D, information technology and finance. It goes without saying that achievement of that target requires significant investment in capital, brainpower and personal commitment.

Expectations

Make your expectations realistic, but tough. Setting stretch objectives involves an honest internal assessment of where you stand in comparison to what other companies in similar situations have achieved, and then the establishment of a few measurable "wow" objectives.

Pick three to five goals, or sets of expectations, starting with cost. All cost savings should be hard — and verified by a finance officer and the stakeholders in the business units. The standard approach is cost this year versus the previous year ("year-over-year").

Here are two examples of top-line and bottom-line objectives:

1. New product development cycle time:

Would reducing the time from product concept to shipping that new product improve your competitive standing and win new sales? Can you reduce that cycle time by 50 percent and get to market before your competitors while also reducing total cost of sourcing and manufacturing?

2. Total cost of ownership. This relates to reducing not just the purchasing acquisition costs but also the “cost in use” during the manufacturing and shipping process, including costs of returns and defects. R&D, operations, quality assurance and logistics can all participate in selecting the right suppliers, the right material specification, etc. Everyone who is a stakeholder in the process must be a participant in the objectives as well, with something at stake (e.g., their annual bonus).

These are good stretch objectives that make a real difference to the business and have a direct impact on improving return on invested capital.

Supply Management’s Role

The term *supply management* refers to the concept of purchasing as a strategic, supplier-facing function. *Supply chain management* is the management of materials, services and products all the way from extraction of ore to the delivery of products to the final customer. Supply managers operate as a key functional group in the supply chain and sometimes even run the supply chain. The terms supply management and supply chain management are often used incorrectly as synonyms.

We need to begin supply chain process transformation by looking at the work — the process, and then the people, and then the organizational structure.

Purchasing is a process within a business. It has inputs and outputs. For every input, there is a human source. For every output, there is a customer. These are the stakeholders in the process, and for optimal performance these stakeholders must be integrated into the process, not merely passive observers of it.

Pick the Right Leader

You need to be very careful in the appointment of your next chief procurement officer.

There are many factors to consider when making this selection, but the most important is the candidate’s ability to work with and lead people. Your new CPO will not be a czar; he or she will be a team leader. And first and foremost, he or she must be able to attract and retain a cast of extremely talented and highly motivated people. No particular skill set is critical because the required skill sets will constantly change. Furthermore, the ideal leader will also have cross-functional work experience and be a well-rounded businessperson, be credible with key constituents such as operations and finance, and be comfortable interacting with the CEO’s office and the board of directors.

Corporate Structure: Lead from the Center

In the 21st century, it has become clearer that purchasing is a game-changer and needs to become a serious part of the structure conversation.

There are three common types of procurement organization structures:

- **Centralized:** The leader normally has a title of CPO or senior vice president of supply or purchasing and has formal profit-and-loss responsibility.
- **Decentralized:** This can be led at either the plant or the business unit level. In centralized systems, purchasing often reports through finance; in decentralized systems, purchasing often reports through manufacturing or operations. This approach is more plant focused and tactical.
- **Hybrid:** Often called “center led,” this approach can capture close to full benefits of a centralized system and avoid serious disruption of corporate culture. Normally led by a CPO or senior vice president of supply, the hybrid structure includes a small corporate purchasing staff that establishes policy, coordinates cross-enterprise strategic sourcing teams, provides training, and establishes standards in ethics and stewardship.

Innovation and Technology

One definition of a best-in-class purchasing organization is willingness to innovate.

Successful early use of a winning supply chain technology tool can lead to significant competitive advantage.

Technology is defined here primarily as automation and application of computer software to purchasing disciplines.

As a CEO or other senior corporate executive, it is most important to make sure your supply chain team is aware of the latest innovations in software and how they can improve purchasing performance. Make innovation in supply chain one of six or so key areas that you monitor with your chief procurement officer on a quarterly basis and that you personally support.

Establish meaningful metrics to measure its performance. Make sure each piece fits into a long-term puzzle. And remember that your basic purchasing approach must be in good shape before you can order a technology implementation.

Measurement and Expectations

The key to having a credible measurement of cost reductions in purchasing spend is to realize that *three* factors must be measured and reported in order to have a net figure that is relevant to the income statement that senior executives and division presidents look at:

initiatives (purchasing projects), volume fluctuations and marketplace factors (e.g., natural gas price fluctuations).

The total (net) of these three changes will fairly closely align with the results coming out of a company's accounting system. When this is the case, it greatly enhances purchasing's credibility.

Transformation

With key elements in place, what else do you need to have in place so that progress can continue once your initial leader moves on?

Ideally, of course, you would fill the shoes of your initial leader with another true leader. But if that is not immediately possible, it becomes even more critical that most of the elements of advanced sourcing be in place. In addition, to enhance the probability of successful and sustainable transformation, focus on these two areas:

1. **A solid and ongoing change management or business transformation process.**
2. **A financially linked “skin-in-the-game” process.** Skin-in-the-game refers to personal commitment, and was coined by celebrated investor Warren Buffet to explain situations in which high-ranking insiders put their own money on the line to support companies.

Sustainable Transformation

A successful and sustainable transformation also requires:

- Efficiency.
- A shared need that everyone understands and a perceived benefit of adopting change to address that need.
- An exciting vision of change and what that change can mean to the organization.
- Clear communication about the vision and agreement on the approach, deployment and measurement process.
- Elimination of obstacles.
- Executive actions consistent with the vision.
- Reinforcement of the changes being adopted, typically by celebrating success.
- An integrated, rigorous leadership discipline to “stay the course” with both the plan and the change management process. ●

Post-Transformation: Best-in-Class Examples

Suppliers are corporations' most important allies in the competition of global supply chains. Curiously, it is only a

very recent development that Western companies attempted to share even very basic information with them.

When R. Gene Richter assumed the top procurement post at IBM in the 1990s, he discovered that all IBM corporate information was kept secret. Suppliers were told to make a specific part, but were never told how or where it would be used. “In procurement we were the guardians of confidential information, the guard at the door who didn't let any suppliers know anything. You couldn't have effective collaboration with suppliers... What happened is we woke up. We realized that we couldn't be experts in everything.”

Richter's core point was that American business operated on a system of distrust in regard to just about everything — and especially suppliers. The new business model must be built on a foundation of long-term relationships focused on core business functions — those that are most critical to the future of your company. Identify non-core areas and apply a different model: outsourcing, out-tasking or application of electronic reverse auctions focused on price. In purchasing, supplier development is the holy grail. Another principle tenet of Richter's approach was to recruit very talented professionals and then empower them to work with suppliers and make decisions within a carefully designed framework.

Automotive Purchasing

One of the visionaries of the role of suppliers was Thomas T. Stallkamp, a procurement executive at Chrysler Corp. in the early 1990s, who invited suppliers to participate in cost reduction programs and to join in new platform design.

One of Stallkamp's key moves was development of a program called SCORE, for Supplier Cost Reduction Effort. The genesis, of course, was Chrysler's financial distress. The program was announced in 1990 to a group of the company's largest suppliers. Suppliers were asked to submit written proposals that would cut costs. Suppliers had previously submitted such ideas, but found engineering unwilling to take the time or the risk to evaluate them. The carrot was significant: Suppliers would receive half the payout from verified savings.

Robert A. Lutz, who became president of Chrysler in 1988, recalled that the most important aspect of SCORE was the symbiotic relationship between suppliers and Chrysler: “[We] were really both links in the same value-added chain — and that we could demand price cuts from suppliers till the cows came home, but if we didn't work together to get total costs out of our common chain, we'd just be fooling ourselves in the end.”

Consumer Products

Procter & Gamble (P&G) created a global product supply organization in the late 1980s and built a supply chain organization that included purchasing, manufacturing, engineering and logistics. “Purchases” was organized on a global basis in 1992, even before P&G’s giant business units (such as baby care and beauty care) were organized globally. Purchases staff members were embedded in the global business units, allowing a close alignment with business goals.

Supply management is a corporate priority at P&G because it impacts about 55 percent of the company’s total revenue stream. In some business units, purchasing accounts for close to 70 percent of total delivered product costs. A 5 percent improvement in costs translates into a 20-plus percent improvement in profits. Accordingly, virtually 100 percent of external spend, including advertising, legal expenses and consulting, is supervised by purchases professionals.

Aerospace and Industrial

United Technologies Corp.’s CEO, George David, appointed Kent L. Brittan as vice president of supply management in 1996. Brittan had been chief financial officer at Otis Elevator and had a clear mandate from the CEO to seek efficiencies on the supply side.

One of Brittan’s first impulses was to eschew the concept of “purchasing.” “The word purchasing or procurement does not really describe what we do,” he said. “It’s one element. But quite frankly my job is to think about the future and give direction to the company. I interface with a lot of people in this company including engineering, manufacturing and quality. And because of UT500 [an initiative focusing on general procurement], I interface with division presidents on a regular basis. The word *purchasing* itself is an important element of what we do. Obviously the words *supply management* and *supply chain management* much better describe the function.”

Brittan used online tools to get attention and demonstrate impact, and then he lined up senior executives to champion supply change. The senior executives are actively involved on an ongoing basis. The fact that the metamorphosis took place in a highly decentralized company comprised of business units with long histories and strong character is even more impressive. ●

The ABCs of Best-in-Class Practices

Strategic sourcing is a fact-based, rigorous process that involves substantial internal data gathering and evaluation, and

Alliances

Thomas T. Stallkamp, creator of the Extended Enterprise in Chrysler procurement, wrote, “Alliances require a complete corporate focus, starting with senior management, to break the paradigm of individual companies building walls around themselves.”

extensive external data gathering and interactions, in order to select the most appropriate strategy and negotiations approach and ultimately select the right supplier. Strategic sourcing transforms conventional purchasing into a strategic process involving all appropriate stakeholders in a company and that can add significant value by reducing total costs relating to purchased goods and services.

To put strategic sourcing into perspective, it is one of three critically important elements in modern procurement: transactional execution, supplier management and strategic sourcing.

Transactional Execution

On a daily basis, there is a need for accurate and efficient transactional execution (often now referred to as just “purchasing”). Here, the focus is on easy and cost-efficient order placement (with suppliers that have been selected by strategic sourcing), order follow-through and expediting (if needed), order receiving, and order payment. In the state-of-the-art company, the end user (not a purchasing professional) places an order into a system that is populated with approved suppliers and approved materials/prices using master agreements or contracts, and that system communicates directly through electronic media with the approved supplier.

On an ongoing basis, there is supplier management, that involves the continuous and active supervision of the supply base. This includes evaluating supplier performance against criteria agreed to during the negotiations phase of the sourcing process, discussing opportunities for mutual process improvement and resolving conflicts. Some of these ongoing activities are tactical in nature; others are strategic.

On a periodic basis, there is strategic sourcing. Intensive strategic sourcing efforts often occur every three to five years for a specific spend category, with active monitoring of the supply market in between those sourcing events.

Purchasing vs. Strategic Sourcing

The distinction between the complementary functions of purchasing and strategic sourcing can be described along three dimensions:

- **The primary mission/objective:** Strategic sourcing involves leveraging the corporate spend and partnering with a small, preferred supplier base, which is capable of achieving continuous (year-over-year) improvements in cost, quality, delivery, technology and service.
- **The planning horizon:** Strategic sourcing planning horizons begin two to three months from today and can extend as far as five years or more into the future.
- **Organization structures and individual competencies:** The strategic sourcing process and activities must be organized cross-functionally to be successful with engineers, manufacturing and quality personnel, commodity managers, and financial analysts. These professionals must be competent in planning, project management, financial analysis, negotiation and cross-functional operations.

Strategic Sourcing

There are a few absolutely critical success factors for strategic sourcing. First, strategic sourcing must be part of an overall, coordinated transformation plan. With that organizational support and context, strategic sourcing has a stronger chance to succeed as an initiative and has excellent prospects for becoming an embedded business process that serves your business well into the future. Without that support and context, strategic sourcing is likely to face an uphill battle.

Strategic sourcing must also have access to cross-functional talent and resources, either through ad hoc team members borrowed from key departments and locations or, even better, through the assignment of high-potential employees to a core team role lasting two or three years. This latter idea has served companies well in terms of both strengthening the sourcing process and providing valuable developmental experiences to employees viewed as having significant upward potential in their careers.

Supplier Relationships

Three interdependent dimensions determine success in supplier partnerships. There is an operational dimension common to all forms of partnership, a cultural dimension and a strategic dimension that applies to deeper enduring relationships of high value to both parties.

In terms of operations, you want to find ways to gauge the flow of information and the compatibility of the partners' processes.

On the strategic level, the metrics will focus on the degree of business integration necessary for a continued strategic fit and on the characteristics vital to a long-term partnership.

Supplier Diversity

A strong business case can be made for supplier diversity programs. Demographics are shifting; minority groups are growing rapidly and are projected to grow even more rapidly in future years. With this in mind, many companies have concluded that sourcing with minority businesses makes sense because these groups represent an ever-expanding customer base.

The current definition of a minority or women's business enterprise (MWB/E) is a company that is at least 51 percent owned, controlled and operated by one or more minorities or women.

Low-Cost-Country Sourcing

Low-cost-country sourcing is also an important, but complex, tool in the arsenal of best-in-class companies.

Low-cost-country sourcing requires a strong foundation in strategic sourcing, plus strong global and regional market knowledge; an ability to monitor changing economics worldwide; a careful identification and assessment of all cost factors; and a willingness to invest time, people and money to convert the *possible* economic advantages of sourcing from (or outsourcing to) a new country into *realized* benefits.

Negotiations Management

There are three major phases to successful negotiations, and most people in their personal lives, and many corporate purchasing departments, only focus on the last phase:

- **Build a fact base.**
- **Develop a carefully thought-out and appropriate strategy.**
- **Negotiate/buy.**

Strategic sourcing is a modern, disciplined, fact-based and rigorous process. To avoid losing the benefits of the entire sourcing process, the negotiations management process must be equally rigorous and fact-based in its development and execution.

Contract Management

A key ingredient in approaching sourcing and negotiations in a more strategic manner is to plan ahead. Sometimes that means initiating the market analysis phase of strategic sourcing *far ahead* of the contract expiration.

Good contract management includes information that allows you to know with certainty the expiration dates of all commitments to every supplier, provides easy access to the commercial terms of current contracts and enables you to plan ahead.

Risk Management

Successful risk management involves proactively identifying and managing risks, with a focus on minimizing the potential financial impact on the corporation. For each corporation, there is some level of risk that the corporation is willing and able to assume (sometimes called the corporate risk retention level). The capability of the corporation to assume risk is heavily influenced by its capital structure, liquidity and business outlook.

Financial risk management is typically called *hedging*. It is probably appropriate for every corporation to do certain amounts and types of financial risk management. Hedging is a strategy used to offset (and thereby reduce) risk, generally accomplished with options (caps), swaps or costless collars (which often have no up-front costs, the upside cost is capped and the downside price is set). A perfect hedge is one which eliminates the possibility of future (additional) gain or loss by exactly offsetting the exposure being hedged. Most hedges are imperfect to varying degrees.

The primary objective of hedging is to reduce volatility and earnings at risk. In many cases, companies that hedge do so to “lock in” prices at or near their business plan levels.

Consultants

There is nothing inherently evil about consultants, but they are not often managed well by the client.

The client should do its homework and carefully select the consulting firm for its niche of expertise, carefully task the consultant, properly compensate the consultant with well-thought-out at-risk incentive arrangements and manage the program/project engagement actively. If the client does all of these things, real benefit can result for both parties.

Outsourcing

Business process outsourcing (BPO) is defined by Gartner as “the delegation of one or more IT-intensive business processes to an external provider that in turn owns, administers and manages the selected process based on defined and measurable performance criteria.”

While the term BPO is a relatively recent development, BPO has actually been in practice for many years in one form or another. Perhaps the earliest example in the procurement arena is in travel.

There are two approaches that have emerged. Some companies do their own deals with hotels, airlines and rental car companies, but utilize a credit-card provider that administers the use of the program. This amounts to “partial outsourcing” of travel. In other cases, companies

Supplier Recognition

Most supplier recognitions for one calendar year occur in April or May of the following year. This is due to the time required to assemble final performance data for the year just ended; time needed to consider all potential nominees; time to prepare the nominations and review them against established criteria; lead time to advise the selected suppliers; and lead times to prepare program materials, print ads for publications, etc.

have effectively outsourced their entire travel program to a professional travel services firm. The benefits of doing so have been straightforward: You can leverage the market expertise of a firm whose entire business is devoted to understanding the intricacies of the particular marketplace and also achieve operational efficiencies by employing the service provider’s technology/systems in-house. Today’s BPO services providers suggest that the benefits of BPO in procurement include these two basic benefits plus other benefits as well.

The objective is to have a recognition ceremony (the “awards ceremony”) that in itself is memorable for your selected suppliers. The ceremony, combined with press releases and selectively placed print ads that publicly recognize your premium suppliers, will generate enormous goodwill with your chosen premium suppliers and give them strong incentive to work hard to earn an invitation to return the following year.

Epilogue

Of course, excellent procurement and supply management is not the only reason that businesses succeed or fail in the long term. However, it is a necessary and critical component. Without excellent procurement and supply management, a company cannot hope to excel in meeting the tough performance expectations of today’s unforgiving business world. ●

RECOMMENDED READING LIST

If you liked *Straight to the Bottom Line*, you’ll also like:

1. ***The Change Masters* by Rosabeth Moss Kanter.** Have trouble adapting to organizational changes? This summary, aimed at corporate officials, shows how changes are necessary — and can be profitable.
2. ***Reengineering the Corporation* by Michael Hammer and James Champy.** Forget about incremental improvement. Here’s how to make quantum leaps in performance by analyzing and redesigning your work practices.
3. ***Tough Management* by Chuck Martin.** Are you faced with shrinking budgets, smaller staffs, shorter deadlines and more demanding customers? You need business strategist Chuck Martin’s fresh, bottom-line approach designed for what really works in today’s business environment.