

Procurement's Role in the Generation and Capture of Value in Supply Chains



Only by understanding the limitations around existing measures of performance, and the nature of value for organisations and customers, can purchasers hope to demonstrate the effectiveness and efficiency of its output.



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Purpose of this Document

The purpose of this document is to examine how the output of the purchasing process contributes to the capture, generation, and protection of value, both directly and, indirectly, through the facilitation and enablement of suppliers and supply chains.

Only by understanding the limitations around existing measures of performance, and the nature of value for organisations and their customers, can a purchasing function hope to demonstrate the effectiveness and efficiency of its output. Failure to use the concept of value risks procurement being constrained, and ultimately threatened, by not being assessed or appreciated for its broader contribution.

Bringing greater clarity to the meaning of 'value,' and how it impacts on the function's deliverables, will help purchasing and supply professionals to:

- Understand the limitations around existing measures of procurement's contribution.
- Articulate value and demonstrate their contribution to its capture, generation, and protection.
- Focus their attention on how and where their efforts will create maximum benefit.
- Focus on the strategies rather than the processes and tools that are available to capture, generate, and protect value
- Help develop more appropriate value based measurements and targets.

The authors believe that the ideas developed in this document are applicable to private and public sectors and to the increasingly important not-for-profit third sector, and will, help to reduce the current dichotomy that suggests that value, and purchasing, is somehow different in each of these sectors.

Brief History of Performance Measurement

By any standards of comparison professional purchasing has grown immensely in status in recent years and there is increasingly clear recognition of purchasing's importance as a key business function. Yet it remains the fact that there is no agreed method of assessing the output or efficiency of purchasing activity, or its contribution in generating or securing value for organisations.

Our modern world has in many ways been brought about by measurement. Our ability to observe and measure the natural world has brought us the many-fold benefits of science, engineering, and technology. Measurement is also extensively used to judge the performance of the many products of these disciplines. So, for instance, as consumers, we will discuss the latest cars in terms of their miles/litre petrol consumption, or read that a new drug has reduced the deaths per thousand of the population to a record low level. It comes as something of a shock, therefore, to realise that the science of measurement is a great deal more complicated than it appears, and that performance measurement, of organisations in particular, is still, after many years and the application of considerable brainpower, a cause of considerable debate and challenges in measurement.

Traditionally, the performance of businesses, and many other organisations, have been broadly measured in the following three ways;

Annual Financial Reports

Built on the foundations of business book-keeping records, annual financial statements report on the company's assets and liabilities, stockholders' equity, long-term debt, net earnings and net revenues. However, even in these relatively few key areas, practices around the world vary because different responses have evolved, due to local practical problems, such as inflation, or the advent of new business models such as leasing.

This is what the International Accounting Standards Board stated in a discussion paper as recent as November 2005¹

“When applied to financial reporting the term *measurement* can give a misleading impression of certainty and objectivity. In daily life, *measurements* are typically made of the physical characteristics of physical objects – such as height, weight, temperature and so on. If accurate measurement tools are employed, information of this sort is objective and uncontroversial. The subjects of measurement in financial reporting, however, are abstract concepts of uncertain meaning such as income and net assets. For this reason alone, their measurement is always liable to be controversial.”

Despite the difficulties above, the first attempts at measuring procurement's performance followed that of financial accounting and attempted to assess the financial benefits achieved. Initially, this involved simple statements of the discounts achieved and from this was calculated an estimate of the monies saved. This approach gathered pace as companies engaged in major process re-engineering in the early 1990s. Whilst the focus often resulted in significant gains, the savings proved difficult to track, and even more difficult to sustain. In the Public Sector considerable resources are still being committed to this end, and a recent report², by the National Audit Office found that despite this effort, £ 9.8 billion, or nearly three-quarters, of the £13.3 billion of claimed efficiency savings were either substantially incorrect, or carried some measurement issues and uncertainty.

Business metrics

Originally annual financial statements were only intended to give an account of the last year's stewardship of the company to the board of directors but nowadays many other groups, both internally and externally, want to use the information for other purposes and this has resulted in the second measuring system, usually referred to as business metrics.

Business metrics refers to the practice of taking basis business financial and manpower figures and manipulating them, usually by dividing one measurement by another, to make it possible to more easily compare and contrast performances in individual companies over time, and between different companies and different industries. The resulting ratios are used both external and internal.

External - business analysts use ratios from company annual reports to advise shareholders, banks, etc. on the relative performance of companies and economic sectors, and to try to predict future performance to help the efficient working of capital markets.

Internal - companies use the above business metrics, and other internal business measurements, (more commonly know as management ratios) to help diagnose situations,

¹ International Accounting Standards Board, Discussion Paper – Measurement Objectives

² NAO Report, The Efficiency Program – A Second Review of Progress, February 2007

monitor performance and help with forward planning and target setting. As an example of the difference between business and management ratios, the former could be sales per employee and the latter, because of the extra information available within the company, might be sale per sales & marketing department employees.

This apparently simple process unfortunately can easily be misleading as Figure 1 illustrates.

The sales growth of firms A & B in the same industry over the last year have been 10% and 30% respectively. It might appear that firm A has performed rather badly. But firm A performance is put in a very different perspective if market share is considered i.e.

Figure 1

Firm	Market Share (%)	
	A	B
Now	55	13
A year ago	50	10

From this perspective, Firm A has performed better with a 5% increase in market share compared with only 3% for firm B.

Management ratios applied to purchasing have included orders or invoices per purchasing employee, or total purchasing department cost divided by the number of orders. The latter has been responsible for many critical comments about orders costing £40 being used to obtain the proverbial £30 hammer! Of course, no mention was made of the corollary that a £20m plant order was also placed for only a cost of £40! The use of such ratios has declined as the emphasis in procurement has moved away from a transactional exercise towards a broader, more strategic role.

Key Performance Indicators (KPIs)

The third and more recent way of measuring the performance of organisations has been the KPI, or key performance indicator. Many companies have taken up this approach on the back of developing a measurement framework approach to managing performance (see separate tool on website). While all measurements have a propensity to skew emphasis to certain aspects of the job, at the expense of the unmeasured areas, often leaving staff feeling that they do not receive adequate recognition for the real variety and totality of their roles. Another frightening aspect of indicators is that the numbers can escalate to alarming levels. It was recently reported that the NHS was going to have its performance indicators reduced from 1280 to 230!

Indicators, however, have an extra unique danger. Lacking the constraints of financial reporting and the relative constraints of business/management ratios, indicators can be anything we believe and choose. This was graphically illustrated when an international oil company was criticised after a deadly plant explosion for using the monitored level of personal injury rates as an indicator of process safety of the plant. In an attempt to avoid similar problems, the NAO³ has published 14 criteria for setting good KPI's, namely that they should be relevant, have clear definition, be easy to understand and use, be comparable, verifiable, cost effective, unambiguous, attributable, responsive, avoid perverse incentives, allow

³ Audit Commission Report, On Target – The Practice of Performance Indicators, June 2000

innovation, be statistically valid and timely and correspond to the performance criteria as closely as possible.

The biggest fundamental problem however is that most performance metrics only measure levels of activity versus activity targets. Typical examples from procurement might be to measure the number of contracted suppliers or to reduce the number of companies in the supply base. One only has to sit back for a minute to realise that such targets say nothing about what contract, versus non-contract, purchasing is delivering, or that reducing supply base as an objective in itself is meaningless. Simon Caulkin (Management Editor of the Observer) made this point vividly in his examination⁴ of the impact of measurement on performance⁴ on the Feb 10th 2008.

It is tempting to think, that with the greater use and integration of computer systems to support organisations, that cleverer business metrics might be developed in the future to mitigate these criticisms and for some, such as delivery performance, quality of goods and service, and whole life costs it is probably true that we will be able to use information technology to give us a clearer picture of these aspects in order to take more appropriate sourcing decisions. However, business complexity continues to expand, and while we await for technology to catch up on yesterday's focus, we will miss out on addressing the new focus on even more difficult areas of sustainability such as corporate social responsibility, the environment, ethical trading, and human rights that are presenting increased uncertainty and risk to brands and the long term profitability of all organisations.

If procurement, therefore, is to continue to be regarded by the majority as a key business process, it must find a means to clearly define its outputs to its varied customers in such a way that does not lead to a never ending multiplication of disparate metrics and KPIs, and in keeping with best marketing practice, it must articulate these outputs in terms of the benefits to the customer and not the features of its services, such as 'number of contracted suppliers', 'the number of suppliers in the supply base', etc.

This paper considers procurements role in the generation and capture of value in Supply Chain, it may also be useful to consider this in the context of the wider business and the objective of achieving value in the Supply Chain. See appendix A for more information.

Members working in the public sector might also want to refer to the Governments 'Infrastructure in Procurement – delivering long term value' March 2008 HM Treasury.

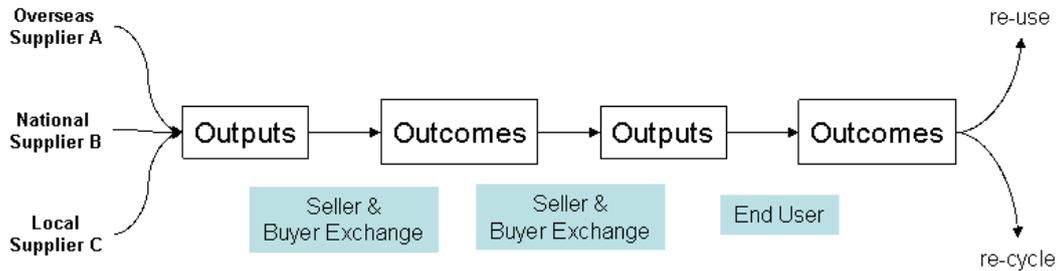
Procurement Role in adding Value in the Supply Chain

Having considered, and learned what we can from consideration of value in general, the next step is to see how this might be applied to procurement, and specifically in modern supply chains, and moreover, to see how supply chain thinking might illuminate general ideas on value. To identify value opportunities in the SC see Appendix B.

As a first step let's examine the implications of the model shown in figure 2. This shows a simplified, but for our purposes, a realistic representation of a fairly typical modern supply chain.

⁴ Observer Business News and Features 10th February 2008, The Rule, Be Careful What You Measure <http://www.guardian.co.uk/business/2008/feb/10/businesscomment1>

Figure 2



The above figure shows two of key features of modern supply chains, namely;

They are getting longer. This is true in the geographical sense that products and services are increasingly being obtained from low cost sourcing countries around the world, but supply chains are also becoming longer because it is becoming increasingly important to go beyond the sale to the end-user customer and consider how a product can be safely and environmentally disposed of, or better still, recycled, in total or in part, for continued use. Both of these aspects clearly have considerable implications for the 'value' in the supply chain. And;

Although the schematic supply chain only shows three component suppliers, the reality is that the numbers of suppliers, and the complexity with which they are combined, one with another, into modern supply chains is considerable. Companies would not have gone down this supply route if it had not yielded cost savings and other aspects of value, but it is also important to consider any downside. If you consider when man first started to produce a surplus over his subsistence needs, it's a racing certainty that the first items he traded were things that he had already made for himself such as a warm coat from his sheep's wool or a pair of shoes from the hide of a cow. In other words, he had first hand experience of the 'value' of the item in question, both from the point of view of the total effort that went into its production, but also from the benefits arising from its use, and this must have guided his decisions when making a trade. In contrast in a modern supply chain there are tens of suppliers and hundreds of employees and, in the end, none of the latter may ever own or use the product or service they are part of producing. This, the authors believe, is in part responsible for many modern organisations focusing on their relative competitiveness, profitability, and benchmarking exercises, rather than an intrinsic view of their of value to their customers.

Although only one schematic supply chain is shown, it represents two situations from the purchasing department's point of view. One is the commonly shown situation of a producer finally selling on to the end-user customer, whether this be another organisation or an individual. In these cases, sales and marketing will generally be responsible for discovering what the end-user customer values and act as the 'voice of the customer'. However, there is another important circumstance, which is too often overlooked, and that is when the purchasing department procures materials that are used to support production and delivery fulfilment of good or services, and if these materials are not consumed in this process, they become assets of the organisation. In regard to these items, the purchasing department stands in respect of the internal customers of the organisation [production managers, maintenance and design engineers, IT, personnel department, and sales and marketing] in the same relationship as sale and marketing to the external end-user customer. The purchasing department, therefore, must, in all respects, discharge the marketing department's role of determining what these customer's value, in general and with regard to specific goods and services.

As VAT recognises, each organisation in the supply chain adds value until eventually the head of the supply chain incorporates all these subcomponents, together with its own added value, to produce the final product. The next transaction in the supply chain, however, is uniquely different because the apex of the value adding process has been reached, and from here on in, value is extracted from the product by the end-user customer. To represent this important distinction, and to generalise it to cover both goods and services, we have labelled the end point of the value adding process, the output, and the value extraction process the outcome. Traditionally, in commercial organisations, the buy/sell transaction has been seen as the culmination of the supply chain process with the output being exchanged for money, but, in reality, this is just the beginning of a new chain of events which may well last longer than those of the value adding stage. Public service organisations are more familiar with the distinction between outputs and outcomes, but because the lack of customer choice circumvents the survival imperative that direct sales feedback gives to commercial organisations, public services have tended to place even more reliance on activity output targets, rather than end-user valuations of individual outcomes.

One immediate conclusion that can be drawn is that the transfer of ownership that occurs on payment of the selling price is the instance at which risk moves from the shareholder, if this is a commercial company, to the buyer, but only time will tell whether the risk was a reasonable one and whether the customer really did get value for money. It also does not matter whether the output is goods or a service. For example a vehicle manufacturer's output might be a car with the buyer's outcome being a comfortable, reliable means of transport, whereas in a service example, a surgeon's output might be hip replacement operation, the outcome of which for the recipient patient is a new life of increased, pain-free, mobility.

The point has been made that value is commonly extracted over time, and more often than not, great value is associated with longevity and durability. Earlier, we also mentioned human 'values' is an increasingly important consideration. One of the key attributes of human 'values' is their immutability and independence of time. It is therefore interesting to consider that this notion of value is itself intimately linked with the concept of trust and sustainability and that perhaps our contribution to sustainability (in terms of realising organisational and brand values, extending durability, minimising resource use and negative external impacts) is entirely consistent with the value-based approach to procurement suggested by the authors.

When money exchanges hands, we should note the direction and look for the real value and risk, moving in the opposite direction. Unlike commercial operations where money is obtained from individual customers, in the public sector, money often comes from central government and so the value chain model suggests that it's the government on the receiving end of real value and risk. This helps to explain why so many public services have objectives and targets such as diversity, use of SMEs, and local procurement. These are all valuable objectives to national and local governments that have responsibility for the general economy, but would not be judged by service users relevant to how they experience and value a service. However, while the government might have gained the value in terms of benefits for the general economy, the risk that transfers with it might result in the service users rejecting the government at a general election because they have not seen the value themselves. There are clear dangers if a situation like this occurs. The risk is that a service is out of line with the needs of the service user. As the very least, this creates potential waste – which is value destroying and, more seriously, perhaps results in the service user 'rejecting' the value proposition that is being offered to them.

This leads us to consider that using the procurement process to deliver broader policy (eg. local regeneration) which is not directly part of the 'value exchange' can only be justified if it creates value for the organisation itself. So, for example, investing time to build the capacity of local SME's can only be justified if it delivers a more dynamic supply base to benefit the buying organisation (eg. by reducing costs or supply risk). If not, whilst the policy objective may be valid, alternative mechanisms (other than the procurement process) perhaps ought to be used to deliver it.

Shareholders put proxy value into commercial organisation in terms of the money they pay for shares and they receive their 'value for money' in the same proxy terms as dividends, which in turn are broadly related to the difference between the selling price and the total production costs, i.e. profit. Under these circumstances it is very easy to start to see the organisation in terms of money and to concentrate on this real value proxy, an attitude sometimes referred to as bean counting, and because it is the finance department's responsibility to oversee all the movements of money, and have custody of the monetary equivalent of assets, blame for this attitude is often unfairly attributed to them. So, for example, when the CEO calls for the profit level to be improved, marketing might well suggest a price increase which might work in the short-term, but effectively reduces the value to the customer. Western car companies have often tried to get out of loss making situations by employing this tactic, whereas the Japanese sought to increase their value proposition by including many additional features within their standard prices, a strategy that has resulted in them taking an increased share of the global car market. So even when CEOs demand cost savings through redundancies, the value chain model clearly suggests that the best approach is not to calculate how many must go to equate to the savings demanded, and then worry about managing the reduced teams but to first look at how current staff add value, and mitigate risk, in return for their salaries, and to consider other ways in which this value, or more, might be generated.

In a very real sense each step in the value generation process, through to the end user, creates a sequence of transfers of risk until the product or service reaches the end of its life. This becomes a key part of the 'value exchange' discussion between the buyer and seller throughout the process with each side trying to protect its own value and to defray and minimise the degree of risk it faces during, and after, the value exchange. It follows that protecting value (as well as trying to generate more of it) is central to professional procurement responsibilities.

Key Points from this Section Are;

- The key objective of defining value in the SC is to optimise net value to the end user at a low cost
- As buyers we need to understand what 'value' means for the customer whether that is internal or external, or BOTH, as well as the Supplier
- Procurement's purpose is to determine and fulfil value needs by engaging the market and suppliers in the most effective way
- Value risk transfers to the customer at the point at which the 'exchange' takes place, but the value is only assured after the customer has consumed the product or services and after it has met the promise, or expectation, defined in the producers "output" or "utility". Any failure to deliver a customer or end-user promise results in a loss of TRUST
- This view of value is aligned with the Objectivist Theory of Value which holds that items have built-in properties or attributes and that human beings make judgments of worth or value, based on how well these meet their needs. In this way the properties are in the items, but value is in the judgement of the user. Properties beyond the product itself, such

as continuing supplier services, social, economic or environmental benefits or an organisation's 'values', are also part of the customer's value judgement.

How Purchasing Adds and Protects Value

We can now begin to see how by focusing on value exchange, and applying the concept to the large number of identified opportunities across the supply/value chain, purchasing can align its organisation's value needs with the best market and supplier solutions in ways that maximise value gain and minimise costs and risk. This should not be a passive or process led activity. The procurement role is to actively work at the interface between all 'producers' and 'customers' in the value chain, whether internal or external to fully understand the value equation at the point at which "output" becomes "outcome". Working critically, to make sure that the value "need" is fully understood and fulfilled in the lowest cost way possible.

In economics and finance, 'arbitrage' is the practice of taking advantage of a price differential between two or more markets and what skilled procurement professionals seek to exploit is the 'value arbitrage' between different markets and suppliers on behalf of their organisation.

We have shown that added value for an organisation is the extra value when all costs have been subtracted, and, correspondingly, the value added by functions such as procurement must take into account its own additional resources and cost. The baseline here is what would happen even if no specialist procurement function existed. The 'value add' for procurement then needs to be set against this baseline position i.e. what does 'professional procurement' offer us against this baseline. Its measure of effectiveness is therefore the 'value add' it generates by virtue of its actions – and its efficiency the additional resources that it needs (in cost and other resources) to achieve it.

The baseline mentioned here is very similar to the concept of basic value and minimum standards as proposed by Kearns⁵. This baseline value we believe should be limited to the man-hours and resources PHYSICALLY involved in day to day procurement and delivery of the good or services required to produce the organisation's output. So in the case of procurement, whether performed by the purchasing department or anybody else, the writing of orders, the receipt and storing of the goods, issuing of goods and payment of invoices would all come under this category. In many respects this view of basic, or baseline value, would equate with the previously mentioned labour theory of value that states that it is equal to the direct labour input. Everybody else then who is not physically involved in the basic value creation process has the role of adding value and must be capable of articulating how this is achieved.

Currently the purchasing department's toolkit, and many of the procurement processes, are heavily biased towards cost optimisation and facilitating the commercial aspects of transactions. We now need to re-evaluate our toolkit and processes in terms of their capability to handle value capture and generation and to challenge ourselves to think differently what we do and how we are doing it, so that our strategies are aimed at value and understood for the added value they can create.

Strategy is often seen as the prerogative of the main board of organisations and it is with regard to the long term plans for the total organisation. But individual functions of the organisation can also have long term plans of action designed to achieve a particular goal, and in the case of purchasing, this goal ought to be directed to generating further value. Many

⁵ The Value Motive, Paul Kearns. John Wiley & Sons 2007

purchasing functions historically believe that they only need to be aligned with their organisations’ strategies to be successful. However to maximise value, it is important that the “value conversation” is two way and influences strategies in both directions i.e. procurement needs to bring its own value strategies and opportunities to the table as well incorporating the plans of others.

In the light of our understanding of value, we will now consider five common procurement strategies, namely, aggregation, standardisation, category management, outsourcing, and relationship management and three major tools - specification, tenders, and contracts. We will see how each of these produces outcomes that directly address one of more of the six sources of value.

Aggregation

The first purchasing strategy for consideration is aggregation. Aggregation is one of the first benefits of the creation of a purchasing function. What was previously considered as unconnected individual requirements is now added across departments and sites and presented to potential suppliers as total requirements perhaps over a 12 month period. The usual outcome is for suppliers to offer varying levels of discount based of the volumes presented. This is the simplest of the purchasing strategies and provides a good example of the value approach that we are proposing. First on the principles we have established we need to establish the direction money, the proxy for value, is going and in this case the likely outcome is that suppliers will offer a price discount for the newly established volumes. This tells us that the real value is going from our organisation to the supplier! This may come as a surprise to many in purchasing who would have seen the achievement of a discount as due only to their price negotiating skill, together with being something that our internal customers would thank us for. But remember money is only of real value as a reward to the organisation as a whole and to the shareholders in particular. Only the aggregated items themselves offer real value to internal customer and ultimately the final customer and aggregation has not changed the intrinsic value of the items themselves. It may be a hard lesson to swallow but in aggregating the spend we have created real value for the supplier in terms of potentially longer production runs and reduced selling costs and he has been prepared in exchange, to offer a discount off his list price. Our contention remains that by recognising true value, which we can genuinely manipulate, as opposed to proxy value which we cannot, that we end up creating and generating proxy value, namely profit, for our organisation and shareholders.

It follows that if the purchasing function is creating the output benefit and the supplier is enjoying the outcome value, then we are effectively in this instance the seller and the supplier is the buyer. On this basis, purchasing departments ought to consider the adjunct of selling, which is marketing, and seriously consider the value that might be achieved by marketing their organisation to their supply base!

Figure 3 - Aggregation as a Value Strategy

Cost	Lower costs from reduced number of orders & lower stock holding. Longer production runs, more efficient supply chain and logistics operations. Lower procurement and planning costs.
Price	Lower pricing reflecting lower cost base. More significant purchase volumes creates more market interest and more competitive pressure.
Risk	Lower operational risks, quality losses and operational

	variability.
Time	Downtime due to stock-out reduced. Lower level of inventory relative to activity levels, higher stock-turn.
Innovation	Limited or no impact on innovation
Knowledge and learning	Market knowledge from tendering. How different supplier's value volumes of business – value chain analysis. Cost modelling.

Standardisation

Standardisation is one step up from simple aggregation and as such has the potential for creating much greater value. Without some direction from a purchasing function, individual end-users in the organisations various departments will have independently chosen many different suppliers products or services to perform essentially the same task or job. A standardisation strategy involves getting cross-functional teams to agree the requirement for specific cases and then selecting a restricted number of suppliers to meet this need in the future. Unlike simple aggregation, a standardisation strategy involves taking business from the majority of current suppliers and reallocating to the one or two. It is, therefore, not only the increased volumes of business and commensurately larger commitment to the chosen suppliers that influences the additional value that might be achieved, but also the effect of competition between the potential winners and losers in the exercise. A potentially even greater benefit in pursuing a standardisation strategy, however, is that the cross-functional forums provide an excellent opportunity for the purchasing function to discover what elements of product functions and supporting services are most valued by a peer group of end-users. This newly generated knowledge can be utilised by skilful professional purchasers to achieve additional added value for their internal customers, who in turn can use the value of the new benefits to create their own extra added value for the organisation.

Examples of potential value resulting from a standardisation strategy are shown in Figure 4 below-

Figure 4 - Standardisation as a Value Strategy

Cost	Significant reductions in stocking levels because of reduced item variety. Opportunity to explore consignment stocking. Reduced number of suppliers for purchasing to handle. Further savings in acquisition costs because of reduced supply base resulting in lower order & invoice handling. Reductions in training costs because fewer variants. Enables aggregation.
Price	Very significant reduction in input prices because of much higher volumes but also reduced selling costs for the suppliers. Enables more competition for standard items and consolidated volumes.
Risk	Further reduction in risk from stock-outs. Opportunity to negotiate preferred customer status in case of supply limitations. Opportunity for negotiations of long term spares availability.. Reduced complexity reduces risk. Increased marketability – ease of transfer, more credible competitive threat. Commercial risks diminished.

Time	Lower downtime due to stock-outs. Fewer variants mean more staff are familiar with equipment and repair time is reduced. Significantly fewer tenders are required for projects and projects can be completed faster. Timescales for benefiting from innovations is greatly reduced. Supply chain partners benefiting similarly.
Innovation	Baselines established in standardisation process mean that innovations by current suppliers or new suppliers can be more readily assessed for significant benefits. Less time absorbed managing complexity.
Knowledge and learning	As a by-product of the standardisation process tacit knowledge is codified and learning takes place about what the customer values.

Category Management

Whereas the first two strategies focus on manipulating and repackaging internal factors based on newly generated knowledge, a category management strategy is proactive and aimed at generating new knowledge of the marketplace itself. Some buyers see only the ‘category’ aspect of the strategy and as a result interpret their responsibility as being only to simply facilitate the routine transactions that fall into their category, and ignore the management part of the job. The true power of category management is achieved by selecting the right level of classification of the organisation’s requirements and using the insights this provides to probe and discover new market based value. This is best explained by an example. If an organisation needs glass bottles and appoints a ‘glass bottle’ category buyer, then it is only going to get expert procurement of bottles made of glass. However, if the organisation creates a ‘container’ category buyer, and the management aspect of the role is treated seriously, then proactive innovation in terms of alternative materials to glass and alternative containers to bottles, becomes a powerful methodology for capturing significant added value.

Examples of potential value resulting from a category management strategy are shown in Figure 5 below-

Figure 5 - Category Management as a Value Strategy

Cost	By carefully selecting categories, opportunities for substitution and innovation can be examined for process and conversion benefits, reduced waste and losses, and environmental benefits. Greater depth of knowledge – stronger market awareness. Better anticipation of supply chain and product/service changes. Greater opportunity to influence and shape events. Translates to longer term cost reductions.
Price	Category management can reduce input prices by revealing lower priced alternatives or by increasing the competitive pressures from widening the range of potential suppliers or by developing alternatives.
Risk	Knowledge risk reduced. Operational, financial and reputational risks all potentially reduced by greater market awareness and product or service knowledge.
Time	Improved market knowledge increases pace of innovations and change management capability. More strategic understanding and structure increases ability to manage change securely.

Innovation	Innovation depends upon numbers attempting it and the widest range of perspectives, and the global marketplace provides ample opportunity. Stronger linkages to internal business strategies increased dialogue and alignment enhances supplier contribution and innovation.
Knowledge and learning	Category management provides a structured way to gain knowledge and learn about different markets and to benefit from value arbitrage. Creates a subject body of knowledge. Category Manager is the custodian of sourcing strategy on behalf of the organisation.

Outsourcing

There is a lot of confusion about outsourcing because it's arguable that purchasing would not exist if there was no outsourcing and organisations did everything themselves. Considering outsourcing in the context of value generation perhaps allows us, for the first time, to see why the proposition makes sense. At the basic level the procurement of goods and service provides what the authors have defined as 'basic' value, a managed transaction. In looking at an outsourced proposition for the same goods and services – suppliers as well as providing 'basic' value are expected to provide added value just as internal functions should do. So distributors who, because of their turnover volumes and local warehousing, create an opportunity to add value (in effect this is an aggregation strategy) reflected in better terms of discounts and timeliness. More dramatic value opportunities may be created when entire business processes are outsourced. Many early examples of the latter did indeed rely on the advantage gained from the provision of 'basic' value at lower cost, but the clear trend in successful outsourcing now is having suppliers that because of their specialised experience, scale, or technical, capabilities, can deliver added value as great, or greater, than the equivalent internal function. This thinking also forces the procurement function to think about where it can itself add most value and, in some cases, an outsourced approach may be preferable.

Examples of potential value resulting from an outsourcing strategy are shown in Figure 6 below:

Figure 6 – Outsourcing as a Value Strategy

Cost	The outsourcing area cost are removed BUT the outsourced service supplier must now be required to add value in the same way internal function had to. Outsource supplier has aggregation benefits (supply chain, technology or skills).
Price	The outsourced services now become input prices that need to be assessed in terms of the added value created by the supplier of the outsourced service. If the outsourcing is off-shoring in low cost countries, there should be input price savings. Price becomes an explicit measure.
Risk	The outsource supplier will carry the financial risk (proxy value) but based on the supply chain value model, risk will be transferred to the buyer who must ensure the delivery of real value from the outsource supplier. With expertise residing with the outsource supplier, there is real risk in the purchasers ability to exercise the necessary control. e.g. problems of outsourced Railtrack maintenance.

Time	An outsource supplier should be able to deliver improved value far more quickly that could be achieved in-house. Service terms are more explicit.
Innovation	Because the outsourced service suppliers will major in the service, immediate and then medium to long term innovation can be expected.
Knowledge and leaning	The knowledge will mainly reside with the outsourced service supplier and this may present a risk unless mitigated by knowledge transfer. Potentially the external supplier's greater knowledge will enhance that of the buying organisation.

Relationship Management

The fifth and final strategy is relationship management. In the past when goods were obtained from the marketplace there was often a tacit assumption on the part of the procurer that this was a singular event. Unfortunately, this ignored the future possible need for spares or training that might be required for the end-user to continue to derive utility from the previously procured goods. An example of what we have described earlier as the difference between output and outcome. Thus, in the vast majority of value exchange cases, whether we like it or not, an ongoing relationship will exist and we can either choose to ignore it until we are forced by some event to acknowledge the fact, or we can proactively manage the relationship to capture and generate value. The purchasing department should see one of its main roles as facilitating and enhancing the exchange of information and knowledge, via its relationships with both internal customers and suppliers so that other, and additional, added value opportunities can be captured and generated. Whereas in the first four strategies the often ongoing supply of goods and services, together with formal term contracts, provide a useful basis for the development of the relationships, pursuing a relationship management strategy requires the purchasing function to also develop alternative relationship methodologies so that opportunities for added value generation with other suppliers in the marketplace are not overlooked. Dependency (buying organisation on the supplier or vice versa), and the number and diversity of supplier relationships also significantly influence risk and the ability of the buying organisation to secure value over time. The key point here is that relationships need to be managed as an integrated part of the procurement process, and not considered in an ad-hoc way or as an overhead burden to be avoided.

Examples of potential value resulting from a relationship management strategy are shown in Figure 7 below-

Figure 7 - Relationship Management as a Value Strategy

Cost	Using term contracts as a vehicle, relationship management seeks to harness both parties knowledge and expertise to take out costs across the supply chain.
Price	Where the relationship results in cost reductions in the suppliers' value generation processes, the buyer would expect to achieve lower input prices without compromising the suppliers margin.
Risk	A key objective of relationship management is to provide a structure that will better identify risk in the supply chain and, therefore, reduce it for both parties. Customer and supplier intimacy reduces risk. Risk arises if relationships are not well founded, particularly in terms of ethical sourcing and sustainability.

Time	By managing the on-going relationship and sharing more information, the dynamics of the supply chain are improved and wasted time is reduced. Cultural barriers are reduced. Communication is more efficient.
Innovation	By managing the relationship, innovations by suppliers will be picked up sooner and often ahead of the competition. Often preferential access can be secured.
Knowledge and learning	Relationship management is an important strategy engaging with the market and learning about value chains and exercising value arbitrage is becoming increasingly important for maintaining competitive advantage and sustainability. Suppliers are a source of market knowledge. Create the ability to generate new knowledge and insights by working together.

Tools to achieve Value Strategies

Strategies need physical tools for carrying them out and the three main tools available to professional purchasing to enable the capture, generation, and protection of value by the above strategies are specification, tendering, and contracts.

Specification

Many buyers see the specification as minimum information needed to successfully order the required product or service but ideally it should detail all the ways that an internal customer expects, or desires, to extract value from the product or service in both the short and long term. Some requirements will be common to many customers and will be familiar to the supplier, but specific organisations will have such a wide variety of unique circumstances and individual staff preferences, that no amount of marketing research will be able to successfully understand and encompass the totality of wants and needs. Purchasing functions that embrace value as their central tenet will see the preparation of specification as a key opportunity to probe the customer's broader needs and, therefore, the support or additional services that the customer would value, because they enable him to do a better job and ideally to create his own extra added value for the organisation. Sometimes, for instance, detailing how the customer intends to use the product, in addition providing the product description, will prompt the supplier to suggest alternatives or modifications to the product. An example could be a 4 by 4 vehicle might be mainly intended for either use on or off the road and knowledge of this would enable manufacturers to recommend different suspension settings for the two cases. For larger procurement exercises, a more formal business case proposal should be utilised to identify added value opportunities and potential risks, which then can be more accurately matched to supplier profiles in a process of value arbitrage.

In using the specification to identify positive value opportunities, we should not overlook over-specification by the customer, or by the supplier. A good supplier marketing department will have identified the strengths of their organisation from their own point of view and will have priced their products and services accordingly. A good specification in value terms will also provide astute purchasing professionals to question the supplier's pricing strategy, with a view to avoiding paying for aspects of a supplier's offering that does not add value for the procurer's organisation. Examples might include a suite of international subsidiaries when yours is only a national organisation, or a long-life product, when you are aware the plant it is intended for has a limited life expectancy.

The above might be described as ways of discovering and capturing the useful value the marketplace and individual suppliers have to offer, but there is one very important additional step that the buyer can achieve, by skilful preparation of the specification, and that is to involve the suppliers in creating additional specific value for the buyer's company. This is achieved by producing a specification based on the outcome required, rather than a specification of the output from the supply base. By this means, instead of settling for a product or service from the supplier's established range, the buyer is harnessing the total knowledge and creativity of the supplier to produce a product with values exactly matched to the buyer's requirements and, therefore, the outcome should be close to being 100% effective. Of course the supplier will have to be convinced that the reward is sufficient to merit the commitment of their proprietary knowledge. Creative industries such as marketing and advertising can really only be effective if this approach is employed and, increasingly, it is being used to improve social, economic and environmental impacts within sustainable procurement.

The final specification is a representation in words of what the parties agree defines 'value', or the conditions or performance the product or service has to exhibit for value to be generated further along the chain.

Tenders

The reversed roles of seller and buyer that was mentioned previously applies when the tendering tool is used. Instead of going to the suppliers' market to look at the range of products on sale, the buyer is setting out his stall of his requirements as defined in the enhanced specification described above and, additionally, marketing his organisation's attractiveness and benefits to the suppliers who respond with offers that they hope will be sufficient to allow them to 'buy' the business being offered. Clearly a primary attraction will be the volume of business on the table and their offer is likely to include a discount on their standard list prices. But answers to other questions based on the enhanced specification of value and general questions about the supplier and his business will be key areas to be compared with others, responses and mined for the crucial extra value.

While there may be a temptation to revert to tactical mode and attempt to obtain minor discount concessions, in most cases this should be avoided as the real value opportunity is to learn more about the supplier, the supplier's supply chain, and the industry sector. The suppliers responding to the tender will be at the head of that product's supply chain and there is an excellent opportunity to learn about some of the key features of the supply chain and the industry in general. Some knowledge that is exchanged in this process will quickly devalue but much will retain its value and can be stored for re-use in subsequent years.

When using the tendering tool to unlock the value you are searching for, you should remember that you are as much in a marketing and sale situation as a buying one. Your requirements should be packaged in a way that makes them most attractive to the market. Marketing professionals always stress the benefits rather than the features. Bearing this in mind, and in the spirit of value exchange, be prepared during the negotiation phase to provide concepts and arguments that the relationship manager can use back in his own organisation to justify concessions he may have granted.

Term Contracts

Finally the term contract is the purchasing department's tool to ensure sustainability of the value that has been exchanged to provide the outcomes needed by the customer and the added value that has been achieved with the tendering tool. Orders are an excellent tool for procuring a one-off event and are often used under the umbrella of a contract for this purpose, but for issues that have to run forward in time, such as future spares pricing, price

stability periods, extended warranties, etc., the term contract is the main tool. It is also a necessary tool because some of the clauses, covering areas such as the availability of spares, may run for many years into the future, long after the original negotiators have left the scene.

To ensure that value is actually delivered, the performance of the contracts should be monitored, and periodically reviewed, with the supplier. However the contract should not just be seen as a tool for registering established value, because it can also be a powerful tool for supplier development and innovation, targets for which can also be written into the contract and reviewed at agreed intervals. There is one key source of material for supplier development that comes from using the tender tool, and should appear in every contract. Having chosen the final supplier as the one that gives the overall best value, it is extremely unlikely that this supplier also provides the highest value in all value categories. Therefore, areas in which the chosen supplier showed value deficiency should always feature in supplier development improvement plans in the final contract.

Incorporating the specification and other standard terms and conditions, under which the goods or services are to be provided is the final stage in PROTECTING value – by locking down the rules which govern how the value exchange is to take place, and under what conditions those rules can be changed.

Conclusion

To conclude, we have shown that the output of the purchasing department is value in many different forms, and for a variety of customers, including suppliers. Performance, if it is not to become a scheme of box ticking or compliance measurement, must be the judgement of the purchasing department's customers as they consume the value over time. However, by making value the objective and output of the purchasing department we are at least now talking in the language of our customers and not in activity levels such as number of new contacts or the number of contracts under management. Contracts are just tools in the process and like with carpentry, it's the fine furniture that provides the value to the customer, not the hammers and saws the carpenter uses in its production

The tabulation that the authors have produced to show the large number of areas where the purchasing department can search for value, should make it equally obvious that any attempt to find single simple measures to sum up the value outcomes is doomed to fail. The authors suspect that part of the pressure for measurement and targets comes with the concern that purchasing departments, while claiming to be strategic, have in practice still pursued a tactical approach, and this rightly causes anxiety because results are very much down to the capability, motivation, and inclination of individual buyers. All functions should be working towards the strategic objectives of the organisation, but this in itself does not guarantee that the departments themselves are behaving in a strategic manner or delivering value.

In this paper, the authors have demonstrated that purchasing has the strategies and tools to capture, generate and protect value for all its customers in a way that customers can comprehend and challenge. The pursuit of true customer-centred value instead of proxy value, forces the purchasing department to use its specialised tools to formally engage with customers in their own language on a regular basis and this improved and increased communication should, along with clearly defined strategies for unlocking value, reassure senior managements that the purchasing department is producing the expected levels of performance. For more formal purposes, the six areas of value opportunities that have been identified should become the basis of a balanced scorecard. Again, because we are using the

common language of value, and not some spurious activity level, it would be entirely appropriate (and good practice) to have the main customers sign off on this scorecard.

Having hopefully produced a concept and system to ensure the effectiveness of purchasing output, we can turn to efficiency.

It has constantly been reiterated in this paper the importance of recognising that true value has to be minus the costs of producing it. Most purchasing departments have now accepted the transactional work, which effectively equates to what we have defined as 'basic value', is not the reason for the existence of purchasing departments and, therefore, there is an acceptance that this work must be carried out as efficiently, and at as low a cost as possible, wherever and however that may be.

With regard to the important added value work of purchasing departments, purchasers would argue that by providing a clearer view of what the output should be, and a range of strategies and tools for achieving it, will, of itself, mean that time is more productively spent doing the things that have been identified as important.

Value always looks to the future because having produced it, the outcome in general can only be consumed over time. We would, therefore, recommend that instead of looking backwards to measure efficiency, we should look forwards. Purchasing's effectiveness rises in proportion to the degree of value that is released or created over time (which reflects the success of its measures to protect it). Procurement efficiency reflects the resources in people, and other resources it consumes, in order to deliver the value it generates.

Our professional aspiration has to be to increase EFFECTIVENESS by releasing real value and to do this with maximum EFFICIENCY.

Further Reading

Business Relationship Management: The Four Faces of Building Value with Strategic Suppliers.
Produced by IPLF – The International Procurement Leadership Forum
Accessed from www.futurepurchasing.com

Appendix A - The Value in Value Chain Management – By Tom McGuffog

Definitions

The key objective of achieving value in the supply Chain is to optimise net value (NV) to the end user at a low total cost, and also to optimise net added value (NAV) to each of the intermediate participants in the chain. Value means Utility (value in use: the benefit derived). Value is most often measured by Price (value in exchange), or by the charge incurred. This is often referred to as Value Chain Management (VCM) which differs from other approaches to management by examining Processes (physical, financial and informational) and Uncertainties (opportunities for improvement and risks to achievement) from beginning to end of the chain (or network) in an integrated manner in order to optimise overall value.

Therefore, value can often be measured by what someone is willing to pay for a product or service because of its utility. NAV at each stage in a Value Chain and also overall, often means the difference between Price (or charge) and Cost (capital, operating, direct and indirect costs) – i.e. the Revenue from Sale less the Cost of Production, which is most often the Profit. The Price of something is usually determined by balancing Supply (determined by its availability,

cost and competition) and demand (determined by its utility, available funds and competition). For example, water is invaluable. It is a necessity. But its Price will be determined by Demand and Supply, not only generally in each region of the world, but seasonally, daily and by location. Thus, the marginal cost of a glass of water out of the tap in a British home is zero; the average cost to the consumer is the annual consumption divided by the water bill; the price of a bottle of chilled water on a boat sailing on salt water in summer is high, and it will be bought if the utility exceeds the price and the funds are available, and if demand does not exceed supply.

Utility is determined by Performance and Timeliness – will a product or service meet a need when required? Performance, in turn, is composed of Output, Outcomes, Throughput and also Quality and Reliability.

Value is greatly affected by Uncertainty (Opportunity and Risk). Thus, lack of confidence in a currency causes its value (exchange rate) to decline, and a general lack of confidence in currencies causes the price of other value stores, such as gold (which has limited utility), to increase. Valuing a product or service in a currency depends on the currency's price (rate of exchange with other currencies), which in turn depends on the complex interactions of demand and supply for all the items being traded in each currency, including speculation and hedging. Valuation is therefore often difficult. Uncertainty in any VC causes costs to rise since steps need to be taken to provide physical or financial 'insurance'.

Value is added over a period of time. Cost too is incurred over a period of time, and Total Cost takes much longer to appear, and it may be incurred, not only by the immediate supplier, but by third parties and by society e.g costs of health, education, transport or pollution.

Value Chain Management Measures

The purpose of Value Chain Management (VCM) is to optimise the Net Value (NV) to the end-user and the Net Added Value (NAV) for each of the Value Chain participants. The chain can be a 'simple' physical supply chain; or it can be a complex physical, financial and informational network interlinking the public and private sectors internationally; or it can be a patient care 'pathway'; etc. VCM is concerned with all the components required to achieve the objectives, and it takes a holistic view of all processes and participants. 'Success' is easier to measure where there is a Price and a Profit. However, many services, public or charitable, or functions within a business, have no price, only a cost. Therefore VCM must also concern itself with the Cost Effectiveness by which agreed objectives are achieved. VCM also uses Cost/Benefit Analysis to compare tangible and intangible benefits with the costs of providing them. Value for Money Analysis attempts to compare different ways of achieving the same end through Cost/Benefit Analysis – which way will produce best value for money? Other related terms are Value Analysis and Value Engineering.

Often values are implied. Thus, what is the value of a human life? Various parties take very different and often unpublished views of this e.g. a court of law determining compensation; the NHS determining whether a treatment is to be made available at all; a doctor determining whether a particular individual will receive that treatment; a patient believing that his life is worth preserving because he has paid his taxes all his life; the Armed Forces in battle; or a religious denomination's definition of the sanctity of human life.

Improving NV to the end user and NAV to the value chain participant often involves focusing on stocks and flows. Generally, stocks should be relatively low and flows should be relatively fast. The objective is to achieve agreed speedy AND certain service levels at a low total cost. The total costs of production and distribution capacities need to be considered (including balanced capacity utilisation). Thus inventory needs to be sufficient to meet an agreed level of

service and at the same time prevent a loss of sales (or of life) or excessive production and distribution costs. Inventory usually costs substantially more than the annual interest on its book value when costs of storage and management waste and write-offs are taken into account (say 25% more). Thus, determining optimal stocks, flows and capacities is a vital but complex part of VCM.

Net Present Value

Since both benefits and costs arise over periods of time, a technique is needed to value these on a consistent basis. Cash (value) flows are discounted to their Net Present Value at agreed rates of interest, which in turn are determined by the opportunity cost of capital (what would the funds earn elsewhere?). While NPV and DCF are relatively straightforward to use in most of the private sector, they are more difficult to apply in social and political situations. It is easy to work out whether a warehouse should be rented or bought given an agreed rate of interest and a confirmed view on the desired payback period. It is much more difficult to compare the benefits and costs to all parties of, for example, not importing products from developing countries now in order to prevent that carbon footprint from damaging their land and livelihood in 10 to 100 years time.

Earned Value Management

This technique (EVM) is used to assess the progress made to date on a project in relation to the costs already incurred, and thereby to forecast what still needs to be done, what it will cost, and how long it will take. However, little real value is realised until a project is completed, and there is a tendency (especially in IT projects) for the last 10% of a project to take 90% of the time. Nevertheless, EVM is a 'valuable' technique, recognising that Value in this context means the cost of work satisfactorily done.

Estimate of work done to date in relation to time taken measures rate of progress. This is a guide to the time it will take to complete the work. However, calculations must be made on what risks remain and what efficiencies will be achieved in the ensuing stages. Costs incurred to date in relation to work done (and to the budget) measures both current cost effectiveness and possible future costs, when related to revised estimates of work still to be done.

Transfer Prices

These usually relate to the charges made by one VC participant to another, where both have a common owner. Hence they are not usually determined by market forces. When transfer prices are set too low, they discourage the supplier, and vice versa. Therefore, setting the value of an optimal transfer price is an art as well as a science (e.g. in relation to international tax rates), in order to avoid the effects of the law of unintended consequences

Appendix B - Identifying Value Opportunities in the Supply Chain

In commercial relationships, value is being exchanged and the proxy for value in that exchange is money. Money therefore, is an excellent pointer as to where real value lies in the organisation. The authors believe there are SIX ways in which value can be created and protected; each with a number of sub elements, they are;

- A. Input cost in the value chain (including the cost of the procurement process itself)
- B. Input & output price at the point of value exchange
- C. Risk to the organisation's ability to generate value
- D. Time in the process of value generation or exchange.
- E. Innovation that generates value for the next recipient in the value chain and/or the ultimate customer or supplier of the product or service.

F. The acquisition and use of specialist knowledge (i.e. the body of knowledge with which the organisation ensures that its future capacity to generate value is protected)

A. Input Costs in the Value Chain

- Processing and conversion costs
- Cost of waste or losses (eg. landfill, process waste, energy loss)
- Environmental, social, economic costs (CO² emission costs, labour costs, taxes)
- Acquisition and transaction costs (including procurement)
- Lifecycle costs, including R&D, design & development, disposal or recycling costs
- Compliance costs

B. Input & Output Price at the point of Value Exchange

- Price paid for purchased goods or service
- Price discounts (including early payment discounts, payment terms)
- Market price comparators (benchmarks, e-auctions, tendering)

C. Risk to the Organisation's Ability to Generate Value

- Protection and/or mitigation against the risk that would destroy output value for example by increasing cost, reducing the rate of value generation.
- Protection and/or mitigation against the risks that would destroy customer outcome value or failing to deliver on the end-user promise by reducing trust.
- Protection of copyright, intellectual property rights or other specialist knowledge needed by the organisation
- Protection of the brand or reputation of the organisation. This can destroy value (e.g. share price or sales) and limit the ability of the organisation to price its products at a premium to others in the market. (for example by not acting responsibly)
- Protection and/or mitigation against future price increases of purchased goods or services.

D. Time in the Process of Value Generation or Exchange

- Speeding up the value chain or eliminating non-value adding delays
- Reducing time to market (the time taken before value generation can begin)
- Speeding up the process by which new value chains can be set up and become productive (e.g. faster innovation)
- Resolving value chain delays (e.g. disputes) more quickly
- Reduction in inventory and financing costs
- Lost market opportunity Costs

E. Innovation that Generates Value for the Next Recipient in the Value Chain and/or the end user or Supplier of the Product or Service.

- New product or process innovation
- Incremental or step change improvement to the product or service or the means by which is provided
- Use of new business models to deliver new or alternative product or service propositions; business process re-engineering
- Integration of 'Voice of the Customer' and 'Voice of the Supplier' into product design and development
- The rapid adoption of supply market innovations

F. The Acquisition and Use of Specialist Knowledge to Generate or Protect Value.

- Learning from success or failure particularly customers or end users

- Understanding customer, supplier and stakeholder value needs and wants.
- Market, product and supplier knowledge and research knowledge and research

If the role of procurement is to maximise value across the supply chain and to secure it, the “value conversation” it has with its customers, suppliers and stakeholders is critical and the relationship management of all relationships, internal and external central to its delivery.

Sustainability can also be seen in the context of these six value themes. We can add value by creating supply chains that reduce cost (eg. by producing less waste, lower emissions, more sparing use of resources, enhancing durability, reducing associated taxation) or, reduce risk (by achieving better compliance, higher labour standards or more responsible work practices) or, enhance our ability to sustain higher prices (through global innovation, better supplier contribution or through stakeholder trust in brand or organisation).

The six areas identified form the basis of the “value conversation” that all procurement professionals should have with their value chain partners. The aim is to identify opportunities where value can be increased and to make sure that the value generating capacity of the organisation is protected.

What emerges is procurement “Balanced Scorecard”⁶ which has universal application.

⁶ An article by Robert Kaplan and David Norton entitled "The Balanced Scorecard - Measures that Drive Performance" in the Harvard Business Review in 1992 sparked interest in the method, and led to their business bestseller, "The Balanced Scorecard: Translating Strategy into Action", published in 1996.

CIPS Group Easton House, Easton on the Hill, Stamford, Lincolnshire, PE9 3NZ, United Kingdom
T +44 (0)1780 756777 F +44 (0)1780 751610 E info@cips.org

CIPS Africa Ground Floor, Building B, 48 Sovereign Drive, Route 21 Corporate Park, Irene X30, Centurion, Pretoria, South Africa
T +27 (0)12 345 6177 F +27 (0)12 345 3309 E infosas@cips.org.za

CIPS Australasia Level 8, 520 Collins Street, Melbourne, Victoria 3000, Australia
T 1300 765 142/+61 (0)3 9629 6000 F 1300 765 143/+61 (0)3 9620 5488 E info@cipsa.com.au

CIPS Middle East & North Africa Office 1703, The Fairmont Hotel, Sheikh Zayed Road, PO Box 49042, Dubai, United Arab Emirates
T +971 (0)4 327 7348 F +971 (0)4 332 5541 E mena.enquiries@cips.org



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