

# Benchmarking the Cost of Procurement as a Percentage of Spend

By Patrick Connaughton and Christopher Sawchuk

## Executive Summary

Benchmarking procurement cost as a percentage of spend helps companies understand their overall costs to run the procurement organization, including labor, outsourcing, technology and other costs. However, benchmarking is not in itself a solution; rather, it is a systematic discovery of best practices and a stepping stone to innovative, continuous process transformation. By comparing process performance to that of other companies' procurement organizations, problem areas can be identified, letting procurement leaders set new targets and recalibrate operations to achieve better results.

### If you have questions about this research

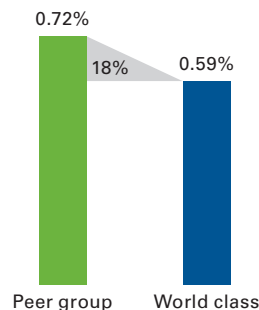
Please contact your Advisory Program Leader or Client Services Representative to set up a discussion on the most effective way to utilize The Hackett Group's benchmark metrics and best practice research.

### Why Benchmarking the Cost of Procurement Is Important

World-class procurement organizations are able to deliver greater value to the business, such as superior spend savings, while simultaneously operating at lower cost – a win-win situation. The first “win” is the lower cost of transactional processes; the second is the ability to reinvest savings achieved in higher-impact processes that deliver higher-value results.

World-class operating cost (i.e., procurement cost as a percentage of spend) is 18% lower than that of more typical companies benchmarked by The Hackett Group (i.e., the “peer group”) (Fig. 1).

**FIG. 1 Procurement cost as a percentage of spend**



Source: The Hackett Group, 2016

## About the benchmark comparison groups

World-class procurement organizations are those in the upper quartile of effectiveness and efficiency metrics, as defined by The Hackett Group’s empirical benchmarking methodology. The world-class performance metrics in this research refer to the median measures for the world-class group.

The results discussed in these pages generally represent aspirational performance for most companies. Accordingly, when companies benchmark their business services functions (i.e., procurement, finance, human resources, information technology), The Hackett Group also provides the median performance for all companies in the database except for the world-class group. These companies represent the “peer group” in our terminology.

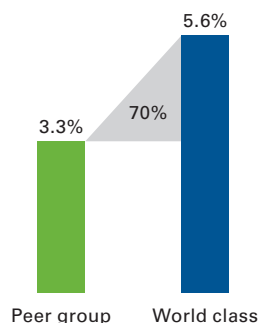
In addition to comparing the current peer group versus world class, we also identify four major peer groups across the full database and use these for benchmark comparison and analysis. These groups vary by two factors: company size and relative complexity.

Company size is rather straightforward and based on the common Hackett Group denominator for that particular function, such as revenue for finance, number of end-users for IT, number of employees for HR, and total spend for procurement.

Relative complexity is determined by a comparison of key drivers for the function involved, including factors such as global scope, number of business entities and level of regulation. In essence, these factors determine the level of complexity that exists in the business, which impacts the cost to execute within a given function’s sphere of responsibility.

This gap is equivalent to US\$1.3 million per billion dollars of spend. The primary effectiveness measure of a procurement organization is its ability to deliver spend savings in the form of cost reduction and cost avoidance (Fig. 2). World-class organizations are significantly better at both. In spend cost reduction alone, they deliver \$18 million per billion more than the peer group, growing to \$23 million when cost avoidance is considered.

FIG. 2 Total savings as a percentage of spend

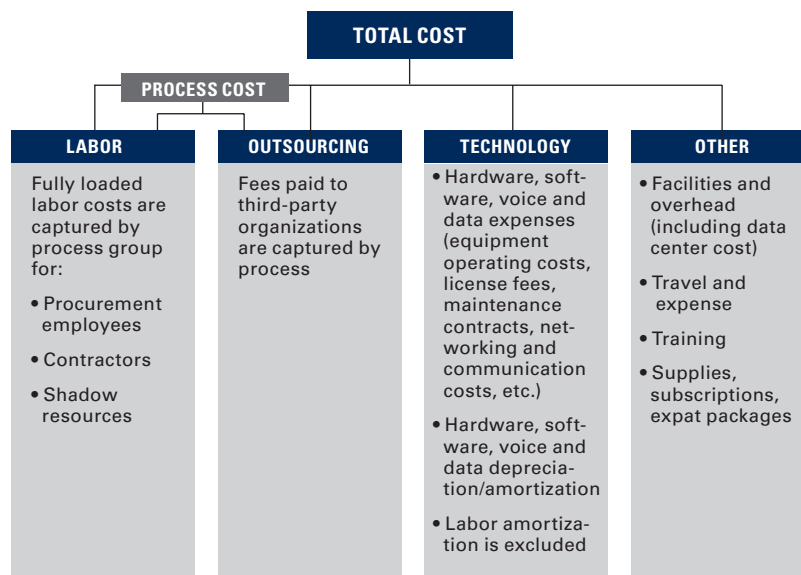


Source: The Hackett Group, 2016

## What Makes Up Procurement Cost as a Percentage of Spend?

To calculate procurement cost as a percentage of spend, we use an activity-based model based on labor and outsourcing (process costs) for all FTEs (Fig. 3). We also calculate technology and other costs (e.g., facilities and overhead, training, travel and expense) for the function. This model gives us a basis for making apples-to-apples comparisons of companies regardless of their organizational structure and level of outsourcing.

FIG. 3 Cost components collected in the benchmark include labor, outsourcing, technology and other



Source: The Hackett Group, 2016

# Performance measures: Essential to effective benchmarking

Performance measures are, quite simply, an organization's vital signs. They tell the organization how healthy it is and how well it performs a specific process or achieves a specified company goal. Rather than using subjective terms like "good," "fast" or "low-cost," performance measures report results in fact-based, precise, quantitative terms – metrics such as "the percentage of invoices processed without error per month," or "total cost of procurement as a percentage of spend."

Used appropriately, performance measures provide employees with concrete feedback about performance and provide targets that explain the extent of improvement expected. If monitored consistently, performance measures also provide another key benefit: they can help the organization identify a process issue before it becomes a major problem that affects business outcomes.

Benchmarking often incorporates performance measures of efficiency and effectiveness.

## **Efficiency = "Doing things right"**

- Costs, such as cash disbursement cost per transaction or transaction costs
- Staff size, such as headcount
- Cycle time, such as days to close books
- Technology utilization, such as integration of accounts payable to general ledger
- Productivity, such as percentage of reports distributed electronically

## **Effectiveness = "Doing the right things"**

- Economic return, such as days sales outstanding
- Quality, such as percentage of accounts payable errors
- Analysis, such as percentage of time managers spend on analysis versus historical reporting
- Access to information, such as percentage of managers performing business performance reporting online
- Strategic alignment, such as percentage of time spent on business analysis

### Guidelines for benchmarking labor costs

Labor cost, i.e., the cost of providing compensation for full-time and part-time employees based on a 40-hour work week, comprises the following: salaries and wages; overtime/vacation/sick pay/personal leave; Social Security/Medicare/health plans; pension/retirement/savings/401k plans; and yearly bonuses.

The benchmark counts FTEs (Fig. 4) as those who spend more than 10% of their time on an activity. FTEs may support multiple subprocesses.

**FIG. 4 FTE scenarios**

SCENARIO	HACKETT GROUP GUIDANCE
<ul style="list-style-type: none"> <li>• Full-time employees</li> <li>• Full-time staff augmentation contractors</li> </ul>	Capture 1 FTE as of the end of benchmark period
<ul style="list-style-type: none"> <li>• Part-time ongoing employees (incl. job sharing)</li> <li>• Part-time ongoing contractors</li> </ul>	Capture fractional FTE (e.g., 0.5, 0.75, etc.) as of the end of benchmark period
Recurring interns or co-ops	Capture FTEs for the duration of time worked during the benchmark period (e.g., 3 months = 0.25 FTE)
Nonrecurring short-term contractors (for projects)	<ul style="list-style-type: none"> <li>• If for a one-time initiative: Exclude</li> <li>• If for IT projects: Capture FTEs for the time worked during the benchmark period, but report in a non-recurring data-collection location</li> </ul>
Full or part-time employee roles not filled for the full year (e.g., maternity leave)	If the role will exist going forward, capture full FTE and annualize the cost. Do not double-count the backfill.
Open positions actively being recruited for	Capture 1 FTE (full-time) or fractional FTE (part-time) as of the end of benchmark period

Source: The Hackett Group

### Guidelines for benchmarking outsourcing costs

In our benchmark study, outsourcing costs are defined as fees paid to third-party firms to manage a process or activity. These include:

- All external costs associated with the delivery of the process or service.
- Temporary workers, if managed on a day-to-day basis by the internal organization's staff rather than by a service level agreement, are captured as FTEs with labor costs rather than as an outsourcing cost in the benchmark.

Labor-related outsourcing includes the external costs to support process activities that, if they were not outsourced, would likely be performed by some type of internally staffed position. Examples include strategic consulting, process-level consulting, manual data entry or other activities in which the internal procurement organization receives support within a process but has limited or no visibility at all into the supporting tools used by the third party, nor the number of staff involved.

Technology-related outsourcing includes the external costs to support processes for hosted applications, online content providers and/or online service providers. A hosted application typically resides on the vendor's system but is visible and actively utilized by internal procurement staff. In cases where a third party is providing both the hosted application and process-related support services, the cost should be split between labor and technology-related outsourcing based on an estimate of the contract value of each of the two services on an individual basis.

### **Guidelines for benchmarking procurement technology costs**

Technology (IT) costs include the annual expenditure to support procurement, including:

- Labor-related charges associated with the development and ongoing support of systems and software applications for procurement (e.g., help-desk, IT and maintenance support). FTE costs are captured as a lump sum in the labor-related technology costs category. Excluded are one-time capital projects such as installation of an ERP application. To be considered part of labor-related technology costs, FTEs may be either in the IT organization or the procurement organization. If reporting in both process and technology, their FTE time or costs may not total more than 100%.
- Charges associated with the use of a computer for running specific functional applications. These charges are typically billed to procurement by the IT department or a computer data center and are based on variables such as transaction volume, connect time, cycle time and storage media/volumes. Exclude one-time capital investments for hardware and purchased software.
- Computer hardware and software. Charges associated with the purchase, lease, rental, depreciation or maintenance of computer equipment, including personal computers, minicomputers, mainframe computers and related peripherals, communications networks and amortization of software. It is important to avoid double-counting hardware costs included in any computer processing charges received from an IT department or computer data center.
- Total annual data and voice-related networking and communications costs, including:
  - Annual data and voice communication cost
  - Landline, wireless, PBX, IVR, etc.
  - Total annual license fees (application software only)

### **Guidelines for benchmarking other costs**

Other costs to factor into total cost include:

- Facilities, which may be allocated by headcount or by square footage related to the procurement organization. Also included:
  - Allowances for depreciation of property and buildings
  - Rent
  - Subcontracting facilities management services
  - Facilities maintenance
  - Cleaning, electricity, gas, water
  - Allowances for depreciation of furniture and fittings
- Annual travel and expense
  - Transportation (airfare, taxi, etc.)
  - Accommodations
  - Meals
- Training
  - Transferable skills training
- Other/miscellaneous
  - Supplies
  - Stationery, postage, subscriptions
  - Expatriate packages (school fees, housing allowance, tax support)
  - All other overhead costs for FTEs included in scope of the benchmark study but not otherwise reported as fully loaded labor, outsourcing, technology or a specified other expense (i.e., facilities, travel or training)

## Strategic Implications

It is important to note that cutting procurement costs across the board cannot, in and of itself, transform procurement; nor does it create an engine for generating year-over-year savings. The key is knowing where cost-reduction efforts will yield the greatest benefit. Further, the goal should be to move away from a transaction-based, cost-center orientation to a profit-oriented service function that helps budget owners get the most value from their suppliers for every dollar spent.

To envision the effect of moving to a profit orientation, calculate procurement's "ROI" by dividing spend savings by the cost of procurement. Peer-group organizations have a respectable 457% ROI, but that figure is dwarfed by the world-class group's 950% ROI. The vast difference is explained by the latter's deliberate choice not to settle for cost savings from lower-value transactional processes, but rather to use them to fund higher-impact sourcing and supplier management processes. To them, a dollar spent on processing purchase orders is a dollar not spent on collaborating with customers and suppliers to improve performance.

## About the Advisors

### Patrick Connaughton

*Senior Research Director*



Mr. Connaughton leads the development of The Hackett Group's intellectual property in the areas of strategic sourcing and procurement. He has over 15 years of experience in supply chain and procurement research and advisory roles. He has published groundbreaking research in areas like spend analysis, contract life cycle management, supplier risk assessments and services procurement. Prior to joining the company, he was principal analyst at Forrester Research, where he focused primarily on helping executives mitigate risk through more effective supplier relationship management. Previously, Mr. Connaughton was a consulting manager at Manhattan Associates and Accenture.

## Christopher S. Sawchuk

Principal & Global Procurement Advisory Practice Leader



Mr. Sawchuk has over 20 years of experience in supply management, working directly with Fortune 500 and mid-sized companies around the globe and in a variety of industries to improve all aspects of supply management, including process redesign, technology enablement, operations strategy planning, organizational change and strategic sourcing.

Mr. Sawchuk specializes in working directly with CPOs to help define a long-term strategy. He has been recognized by *Supply & Demand Chain Executive* magazine as one of its "Pros to Know." Mr. Sawchuk's background includes engineering and operations roles with both United Technologies and IBM.

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