

SPEND MANAGEMENT: Is it a necessary evil?

Several articles and white papers have been written about Spend Management and Spend Analytics. Let's use Wikipedia to define each one:

- **Spend analysis** is the process of collecting, cleansing, classifying and analyzing expenditure data.
- **Spend management** is the way in which companies control and optimize the money they spend.

Companies have invested money and resources in Spend Management with two main objectives: Aggregate spends so you can leverage your purchasing power; and decrease "Maverick" spending (buy from non-preferred suppliers).

Around ten years ago, companies defined Spend Management as one of their key priorities. Last December, Aberdeen published their survey in the 2012 CPO Submit, which shows that Spend Management is the second biggest technology investment and the third critical need in their organization. So, I was wondering why this issue has not been addressed through the years? Why has Spend Management targeted mainly Indirect Spend?

IT Investment

Most of the companies have primarily invested in IT for Sell side and Finance. In the Sell side the goal is to manage each product sold to generate the total revenue of the company. In order to do that, a product code structure was created, so it is well known where and when the product was sold, it is possible to aggregate each product into Families, Sub-Groups, and Groups, and by Business structure. So, the code structure gives the transparency needed in sales.

In Finance, the goal is to aggregate all the costs, expenses and capital, so it is possible to attend the accountant rules to generate the Income Statement, Balance Sheet and Cash Flow. To build the cost, it is first necessary to calculate the Variable Cost which is the unit ratio of each Raw Material, Utilities and Packaging times the unit cost of each one. It is clear that a product code structure is needed in the ERP or an IT system to accomplish this calculation, so from the Purchasing perspective, we are able to do spend management of Direct materials once we have the code structure in place.

The issue arises with Indirect spend because most of ERPs or IT systems do not "force" a code structure for Indirect spend like MRO (Maintenance, Repair, Operation), Logistic (Freight), and other corporate expenditures (HR, Marketing, IT, TE). Accountants, following the rules of credit and debit, define into which cost center each expenditure can be placed to attend Income Statement needs, but not Purchasing needs in terms of spend aggregation.

Spend Management Software

Because of a lack of code structure for Indirect spend, more than 15 companies listed by Gartner, including the biggest ones SAP (acquired Frictionless and Ariba) and IBM (acquired Emptoris), are offering software solutions for Spend Management. They understand Purchasing needs in terms of spend aggregation (and lack of code structure) and provide a solution for collecting, cleansing and classifying the spend data.

The principle is relatively simple: 1. they collect all spend data from different IT systems in a structure form; 2. the cleansing process detects and corrects corrupt or inaccurate data; and 3. by “reading” what was written in the purchase order and/or invoice, it classifies the spend under a code structure. The code structure can be the one defined by your company, or commonly used [UNPSC](#) developed by United Nations with help from several different companies.

The UNSPSC for a given item is composed of five two-digit identifiers, which together categorize the item into a four-level hierarchy. The four levels are: "Segment", "Family", "Class", and "Commodity". For example:

- Segment - 40.00.00.00 = Distribution and Conditioning Systems and Equipment and Components;
- Family - 40.15.00.00 = Industrial pumps and compressors;
- Class - 40.15.15.00 = Pumps;
- Commodity - 40.15.15.21 = Rotary pumps.

Having your spend under a code structure is better than nothing, however the given hierarchy does not match with how the Purchasing function is organized, so there is a need to learn and “translate” that to your organization. Also the granularity is not deeper enough. For the given example, rotary pumps from different materials and dimensions were aggregated into one “commodity”. Moreover, most of software companies claim that they are able to classify a minimum of 80% of the spend: the key question is how much was classified under the lowest level? Because it is at this level is where Purchasing can make a difference.

Solution

There is no doubt that the long term solution is to have a code structure for everything is purchased from third parties, products and services in the ERP or IT system. Also it is a good practice to have a code structure for Vendors so you can have just one name for all the vendors under the same organization and subsidiaries. The most advanced systems now can provide the code at the moment the requisition is typed into the system. The system containing the code structure, can “suggest” alternative codes at the moment it is written, so all the process after that, contains the correct code, so Purchasing, later on, is able to aggregate the spend accordingly.

The down-side of this approach is the cost. It is a big IT project demanding specific resources from Purchasing and IT, because your company cannot stop the systems just to change the codes.

An intermediary approach is to use Spend Management software but using the code structure developed specifically for your company. Spend Management software can be “on-demand” or in the “clouds”, so at a relatively lower cost and will not “touch” your IT system. So, at short-term, you have the spend aggregation as needed, with codes you developed, and later when your company decides to improve or change the ERP or IT system, you will already have the code structure and the historical spend with the same codes.