“Best Practices” Newsletter

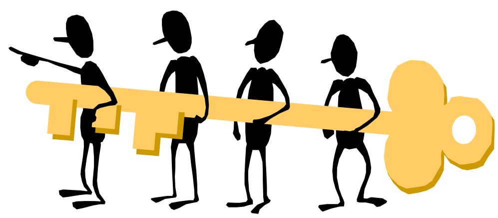
About This Issue

This January 2002 edition of our newsletter contains more techniques to help our clients & colleagues accomplish their strategic procurement objectives.

Strategic Procurement Solutions is a consulting firm specializing in Strategic Sourcing, Training, and Organizational issues related to procurement & supply-chain management. Robert Dunn, C.P.M. & Mark Trowbridge, C.P.M. are general partners in the firm, and lead teams of professionals in supporting our clients.

Visit our web site at www.StrategicProcurementSolutions.com for more information or to contact us about our consulting & training services.

Strategic Supplier Relationships…
by Mark Trowbridge, C.P.M.



A key factor that often differentiates “World Class” procurement groups from old-time ”purchasing” organizations…is their approach to the supplier relationships they manage.

Those that foster supplier relationships as important resources, gain many strategic advantages, such as **Higher Service Levels**, **Continually Improving Product Quality**, **Secure Sources of Supply**, **Greater Expense Base Impact** and **Lower Total Cost**. Purchasing groups, however, that view suppliers as merely sources for goods & services, often miss these benefits.

In our consulting work with supply-chain organizations, determining the quality of their relationships with suppliers can immediately tells us how professional their supply-chain personnel are. Here are some indicators that we look for:

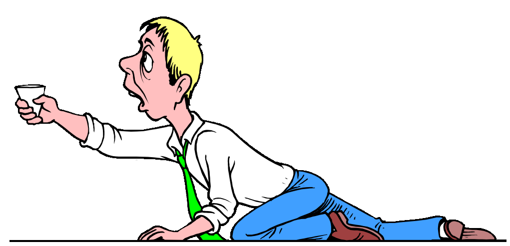
	“World Class” Approach	“Purchasing” Old-Time Approach
Sharing Information	Be open with non-proprietary information, especially that relating to volume trending.	Hold information “close to chest”.

Negotiation Focus	Focus upon total cost or total value negotiations, which provide fair profitability for suppliers based upon the total value received by the buyer.	Focus upon unit prices. Often this can be “penny-wise but pound-foolish”. Buyers who practice this type of methodology often limit their own careers, as they will never progress to managing non-traditional commodity acquisitions like personnel benefits, professional services, marketing collateral materials, information technology systems, etc. Organizations who focus on unit price will never impact the non-traditional portions of their enterprises’ expense base.
Customer Access	Entrust key suppliers to communicate with requisitioners & users subject to contractual controls & automation tools (like eProcurement…). Allow the experts to serve your users…especially in transactions where little value can be added by supply-chain professionals.	Old-time “purchasing departments” are often perceived as a choke point between users and the supplier. For example, organizations that require hard-copy requisitions be completed and mailed…only to issue a hard-copy p.o. several days later that contains the same information, are doing themselves, their users, and the suppliers great disservice.
Trust	Establish contractual controls in advance. Install mutually-agreeable control mechanisms. Manage high transaction volume relationships through exception, for example auditing random samplings of invoices.	Require management to review and approve every invoice. This will alienate the suppliers, your customers, and the accounting group.
Commun-ication	Communicate with key suppliers regularly and in a meaningful manner. Have quarterly performance reviews to identify opportunities for improvement. Have senior supply-chain managers & customer directors attend.	Communicate only when there is a problem. Deal with issues on a “case by case” basis rather than summarizing trends. Have only lower level personnel interact with suppliers.

Entertain-ment	Periodically share entertainment expenses. Don't make it a point to have "extras" be part of the program (they'll find a way back into the product price the next time around…). Adhere to your firm's policies regarding gratuities.	Expect to eat out for lunch regularly at the supplier's expense. Joke about it being their responsibility. Invite non-involved employees. Drop hints about candy baskets for Christmas…
Attitude	Be professional, fair, & personable. Recognize human worth and value provided. Praise good performance.	Be tough. Show them who is the boss. Don't commend them when they do something well.
Respect	Refer to your suppliers with respect. Use terms like "supplier", "business partner" or "provider" in front of your customer departments and management. Recognize that a supplier is one of the best in their field, and they enjoy being appreciated by their customers.	Call them "vendors" (also a good word for someone who sells hot dogs at the ball park…) or "salesperson".

Personally, would you rather work for a manager who treated you in the same manner as the supply chain organization in the left column, or the right? Your approach to the supplier community has the same effect. Over time, it will significantly influence the pricing & service levels you receive…and far more.

<u>Financial Stability Ratios</u>…
by Robert Dunn, C.P.M.



Over the past months, the business community has witnessed the financial demise of many corporations…both large and small. The recent problems at Enron seem to indicate that no size company is exempt from financial disaster.

The recent economic downturn, along with the lack of sound financial management practices, has put many companies at risk. Predicated upon these recent events, it is incumbent upon us as supply-chain managers to monitor the financial stability of the suppliers that are critical to the success of our own organization.

Procurement professionals need to develop methods to analyze the financial condition of their "critical risk" suppliers. Three alternatives are available to most corporate organizations, each with relative benefits:

- **Internal Finance Personnel** – Your own finance organization may be willing to assist with financial analysis. Usually, however, this will be on a case-by-case basis due to limited availability of accounting personnel resources.

- **External Credit Bureau** – Firms like Dun & Bradstreet can provide valuable financial information about medium-to-large suppliers. These services can be pricey, however, and sometimes are not based upon extensive analysis due to the proprietary nature of some firm's financial information.

- **Key Financial Ratio Analysis** - Procurement personnel can track key financial ratio indicators on a periodic basis, applying the ratios in this article to financial information provided by the respective suppliers (usually in the form of a certified balance sheet & income statement). In the event any of the ratios reach questionable ranges, internal finance personnel can be brought in for advanced analysis.

A Key Financial Ratio Analysis can be performed using information provided by a supplier. It is necessary and useful to classify ratios into four fundamental types:

1. **Liquidity ratios**, which measure the firm's ability to meet its maturing short-term obligations. Generally, the first concern of the financial analyst is liquidity; is the firm able to meet its maturing obligations? Although a full liquidity analysis requires the use of cash budgets, ratio analysis (by relating the amount of cash and other current assets to the current obligations) can provide some quick and easy-to-use measures of liquidity. The two commonly-used liquidity ratios are presented below:

    $$\textbf{Current Ratio} = \frac{\textbf{Current assets}}{\textbf{Current liabilities}}$$

    The current ratio is computed by dividing current assets by current liabilities. Current assets normally include cash, marketable securities, accounts receivable, and inventories. Current liabilities consist of accounts payable, short-term notes payable, current maturities of long-term debt, accrued income taxes, and other accrued expenses (typically wages). The current ratio is the most-commonly-used measure of short-term solvency, because it indicates the extent to which the claims of short-term creditors are covered by assets that are expected to be converted to cash in a period roughly corresponding to the maturity of the claims.

    $$\textbf{Quick Ratio} = \frac{\textbf{Current assets – inventory}}{\textbf{Current liabilities}}$$

    The quick ratio is calculated by deducting inventories from current assets and dividing the remainder by current liabilities. Inventories are typically the least liquid of a firm's current assets, and are the assets upon which losses are most likely to occur in the event of liquidation. Therefore, this measure of a firm's *ability to pay off short-term obligations without relying on the sale of inventories is important.*

2. **<u>Leverage ratios</u>**, which measure the extent to which the firm has been financed by debt. These ratios, which contrast the funds supplied by owners as compared with the financing provided by the firm's creditors, have a number of applications. Firms with low leverage ratios have less risk of loss when the economy is in a recession, but they also have lower expected returns when the economy booms. Conversely, firms with high leverage ratios run the risk of large losses, but also have a chance of gaining high profits. Although the prospects of high returns are desirable, investors are averse to risk.

$$\textbf{Debt Ratio} = \frac{\textbf{Total debt}}{\textbf{Total assets}}$$

The ratio of debt to total assets measures the percentage of total funds that has been provided by creditors. Debt includes current liabilities and all bonds. Creditors prefer moderate debt ratios, since the lower the ratio, the greater the cushion against creditors' losses in the event of liquidation.

$$\textbf{Equity Ratio} = \frac{\textbf{Total equity}}{\textbf{Total assets}}$$

A company may use borrowed funds when it expects to realize a return on the investment of the borrowed funds that will exceed the cost of borrowing them. No company, however, should be so dependent on borrowed funds that it cannot survive adverse changes. This ratio is determined by dividing the stockholder's equity by the total assets.

3. **<u>Activity ratios</u>**, which measure how effectively the firm is using its resources.

$$\textbf{Inventory Turnover Ratio} = \frac{\textbf{Sales}}{\textbf{Inventory}}$$

If a company has a high inventory turnover rate, this would mean that they do not hold excessive stock. Excessive stock is unproductive and represents a low or zero rate of return. A high turnover rate also increases the faith in the current ratio. If a company's turnover rate were low, then one would wonder whether the firm was holding damaged or obsolete materials not actually worth their stated value.

$$\textbf{Fixed Asset Turnover Ratio} = \frac{\textbf{Sales}}{\textbf{Net fixed assets}}$$

The ratio of sales to fixed assets measures the turnover of plant & equipment based upon capacity utilization rates.

Total Asset
Turnover Ratio = $\dfrac{\textbf{\textit{Sales}}}{\textbf{\textit{Total Assets}}}$

The final activity ratio measures the turnover of all the firm's assets, which is calculated by dividing sales by total assets.

4. **Profitability ratios**, which measure management's overall effectiveness as shown by the returns generated on sales and investment. These ratios give final answers about how effectively the firm is being managed.

Profit Margin
On Sales = $\dfrac{\textbf{Net profit after taxes}}{\textbf{Sales}}$

The profit margin on sales, computed by dividing net income after taxes by sales, gives the profit per dollar of sales.

Return on
Total Assets = $\dfrac{\textbf{\textit{Net profit after taxes}}}{\textbf{\textit{Total assets}}}$

The ratio of net profit to total assets measures the return on total investment in the firm, or the ROI, as it is frequently called.

Return on
Net Worth = $\dfrac{\textbf{\textit{Net profit after taxes}}}{\textbf{\textit{Net worth}}}$

The ratio of net profit after taxes to net worth measures the rate of return on the stockholder's investment.

With guidance from your own accounting executives, some of the above ratios may prove helpful in evaluating the ongoing financial soundness of your current and potential key suppliers.

Editor's Note: **Strategic Procurement Solutions**' objective is to provide top quality supply-chain consulting & training services to corporate clients in the private & public sector, and to enable those clients to exceed their internal users' expectations regarding promptness, price, and quality. One means of doing this is through this periodic educational newsletter, which provides quarterly articles about "Best Practices" in procurement. Contact us through our web site at www.StrategicProcurementSolutions.com for more information about our services, or if you do not wish to receive this newsletter in the future.