The Real Realized Savings: Creating Positive Impact on the Bottom Line
Procurement has the opportunity to drive strategic value through substantial cost savings, but to gain credibility with finance it will need to close the gap between real and identified savings.

Want credibility with finance? Focus on realized—not identified—savings

Driving savings is a priority for procurement. But as companies move to tackle indirect spend areas, they need to adopt new techniques to ensure that savings are actually delivered, plugging the leakage between sourcing and spending. Just as market intelligence is a critical requirement for procurement to gain credibility with business stakeholders, this new focus on realized savings, and developing the skills to deliver and measure those savings, is the path to credibility with finance organizations.

What exactly is realized savings? The term "realized savings" has become a hot topic in business conversations. Many organizations say they are delivering it, while finance is still asking, "Where is it?" There seems to be a fundamental disconnect between these two groups. Procurement typically claims savings at the point that they are negotiated, while finance is looking to see how much of the contracted savings are actually captured and can be applied to the bottom line. The latter represents true realized savings and requires measurement after spending occurs. This disconnect between contracted and realized savings is the gap that procurement organizations need to close.

With both the imperative and the desire to deliver more strategic and bottom-line impact, forward thinking procurement leaders are raising the bar by putting more scrutiny on how they measure savings. Although there is real organizational value in avoiding cost increases, driving supplier innovation, reducing supply chain risk, and driving supply chain efficiencies, leaders know that these efforts alone are not enough. They know they need to be able to demonstrate that real-dollar savings have been captured by the procurement process.

However, our experience with global procurement organizations shows that focusing on hard-dollar savings is not the answer either. As many companies have experienced, even hard-dollar savings can disappear between sourcing and execution. In the indirect spend arena, savings leakage can occur in many forms and erode the value of hard-won contracted savings. Leaders are taking steps far beyond sourcing and traditional supplier implementation to bring those savings home and measure them in a way that the CFO can confidently take to the bottom line, or reinvest in the business.

This paper defines realized savings, addresses the pitfalls that cause savings leakage, outlines the most common savings methodologies, and recommends steps an organization can take to establish a realized savings discipline and infrastructure.
Why realized savings?

The opportunity to deliver substantial bottom-line financial benefits through savings in indirect categories of spend is substantial. Indirect spend can represent 15 percent to 40 percent of revenues for most companies. In an ideal world, achieving 10 percent savings on that spend could yield 1.5 percent to 4 percent in bottom-line margin benefits. However, the reality is that most companies achieve only a fraction of these potential savings. The level of savings achieved is a function of four key factors:

Spend managed: The amount of spend that is managed via a professional procurement process.

Savings achieved: The level of savings that are negotiated and contracted.

Savings realized: The amount of those savings that are actually realized through compliance management efforts.

Continuous cost improvement: Incremental savings that can be driven post-sourcing.

These first two factors are primarily dependent on market intelligence, the door opener to the areas of spend that are often off limits. This intelligence provides the informational advantage needed to achieve greater negotiated savings. Without market intelligence, companies typically manage just more than half of their addressable indirect spend and suboptimize sourcing results.

The third and fourth factors are dependent on a disciplined approach and infrastructure to drive and measure compliance. Once an organization has established an infrastructure for driving and measuring realized savings it has a basis for quantifying and taking credit for realized savings. It also gains a platform to assess progress and drive continuous improvement.

How do leaders drive 90 percent savings realization? It starts with the right definition and orientation on realized savings, supported by proactive and ongoing management and measurement.

Figure 1: High-performing organizations can deliver five times the bottom-line impact of average companies

<table>
<thead>
<tr>
<th></th>
<th>AVERAGE</th>
<th>HIGH-PERFORMING</th>
</tr>
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<tbody>
<tr>
<td>Benchmark*</td>
<td>Impact on $200MM of annual spend</td>
<td>Impact on $200MM of annual spend</td>
</tr>
<tr>
<td>% spend managed</td>
<td>51% $104MM</td>
<td>93% $190MM</td>
</tr>
<tr>
<td>% savings achieved</td>
<td>7.7% $8MM</td>
<td>12.8% $24MM</td>
</tr>
<tr>
<td>% savings realized</td>
<td>61% $5MM</td>
<td>89% $22MM</td>
</tr>
<tr>
<td>% continuous cost savings</td>
<td>0.5% $.5MM</td>
<td>3% $6MM</td>
</tr>
<tr>
<td>BOTTOM-LINE IMPACT</td>
<td>$5.5MM</td>
<td>$28MM</td>
</tr>
</tbody>
</table>

Source: Accenture [Illustrative example of a Services company with $1B in revenue & ~$200M in indirect spend]
The Everest Research Institute provides helpful definitions for identified, contracted, and realized savings. Realized savings represents the most rigorous methodology for counting savings, and it is the definition that most finance organizations prefer to use. However, most companies are not actually focused on realized savings. Recent survey data highlights that only 22 percent of businesses focus on realized savings, while nearly 70 percent count identified or contracted savings before spending has occurred (see Figure 3). The majority, therefore, thinks that they are driving realized savings, when in fact they are booking identified savings that may not be realized.

**Figure 2: Realized savings vs. identified and contracted savings**

<table>
<thead>
<tr>
<th>Savings Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identified Savings</td>
<td>Savings potential based on analysis of existing spend base, benchmarks, industry best practices, market intelligence and category expertise. Identified Savings are measured as the savings identified by this analysis whether or not those savings are actually delivered.</td>
</tr>
<tr>
<td>Contracted Savings</td>
<td>Post spend analysis, a strategic sourcing and negotiation process results in new negotiated contracts. Contracted Savings are measured as the differential between the new/re-negotiated contracts vs. the old contracts over the volume of purchase for that category.</td>
</tr>
<tr>
<td>Realized Savings</td>
<td>In Realized Savings, savings are not considered valid until spending occurs. Realized Savings are measured as the difference between the original cost (pre-sourcing cost) and the actual price paid. Savings are calculated after the transaction is complete.</td>
</tr>
</tbody>
</table>

Source: Everest Research Institute: “Get More From Your Noncore Spend – Realizing Value from Procurement Outsourcing”

**Figure 3: When do companies count procurement savings?**

*When tackling and delivering savings, at what point do you count the savings?*

- Procurement assesses savings after sourcing is complete: 35%
- Procurement collaborates with finance once sourcing is complete is complete: 34%
- Savings are recorded after spending occurs: 22%
- Expense is removed from the budget once sourcing is complete: 5%
- Not sure: 4%

Only 22% of firms measure realized savings today.

Source: Procurement Leaders PLUS, Controlling the Flow: the Challenges of Indirect Procurement
Without a dedicated focus on realized savings, initial savings begin to deteriorate and costs creep back up (see Figure 4).

**Figure 4: How savings are lost?**

[Diagram showing the stages of savings identification, baseline reduction, and expense creep over time.]

Source: Accenture
Driving savings realization in indirect spend areas differs significantly from direct spend areas

Relative to direct materials where savings realization often occurs somewhat automatically, driving savings in indirect areas can be far more complex and challenging. For example, in direct categories, after sourcing has occurred, raw materials and components are often loaded into a bill of materials and auto-replenished based on forecasts and demand plans. Thus, once contracted, the path from contract to spending and savings realization is fairly direct with relatively few opportunities for savings leakage.

In most indirect spend categories there can be a numerous points of leakage, making it much more challenging to achieve realized savings once they are identified. Consider an indirect expense category like travel. The buyer base (for example, thousands of traveling employees from across the organization) is highly fragmented—multiplying the opportunities for noncompliant spending. These travelers may deliberately choose to use their favorite airline carrier rather than a preferred carrier. Or policies may not be well communicated or enforced, leading employees to inadvertently use non preferred suppliers due to a lack of awareness of policy. Problems can also arise on the supplier side where pricing discounts may not be properly applied, and individual buyers are not well equipped to monitor supplier price compliance.

All of these factors combine to highlight the potential for savings leakage in indirect categories. Alternatively, with end-to-end alignment on driving realized savings, procurement, finance and the rest of the organization (HR, operations, etc.) can create a corporate culture and supporting policies to minimize points of savings leakage. This example also reinforces that counting savings at the point of contracting is premature—realized savings can differ materially from identified savings.

Figure 5: Savings leakage erodes realized savings

Source: Accenture
With the indirect spend opportunity established, and with an understanding of the complexities of managing indirect spend, the next step is to explore the methodologies used to manage spend, and to measure realized savings.

Figure 6 outlines five commonly used savings methodologies, or ways of measuring and counting actual savings realized. The most obvious example is baseline price where savings are measured based on achieving an actual reduction in the price paid for a specific item sourced on a recurring basis.

Note that these savings methodologies all relate to forms of hard-dollar savings. It is important to note that these savings can still be claimed after contracting. If delivering true realized savings is the goal, these calculations must be applied to actual spending data. How a company chooses to measure spend will have a large impact on how procurement and finance teams work together to drive savings.

The key takeaway is that procurement and finance need to align on which savings methodologies will be used to quantify value for which categories, and when. Procurement only gets credit for value delivered, and demonstrating this value requires a new orientation around realized savings. Leading companies measure savings after the point of spend. It is critical to gain alignment on savings methodology so that procurement and finance are speaking the same language and are accountable to the same standards.

### Types of savings methodologies for measuring realized savings

<table>
<thead>
<tr>
<th>Savings Methodology</th>
<th>Description</th>
<th>Application/Example</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline Price</td>
<td>Achieving cost reductions on recurring spend items with consistent specifications and known baseline prices</td>
<td>Recurring items are identified baseline price (i.e. general industrial or electrical supplies)</td>
<td>(Baseline Price - Current Price) * Current Volume</td>
</tr>
<tr>
<td>Cost Plus Markup</td>
<td>Minimizing the mark-up above product cost, or for services, minimizing the mark-up paid above base labor cost</td>
<td>Services like temporary labor (i.e. minimum base wage+mark-up) &amp; value-added products</td>
<td>([Historical Markup % - New Markup %] * Current Spend / (1 + New Markup %))</td>
</tr>
<tr>
<td>Discounted List Price</td>
<td>Measured by comparing the price paid to published list pricing, aiming for the largest discount from list price possible</td>
<td>Products/Services with published list prices (i.e. software, electronics components)</td>
<td>([New Discount % - Old Discount %] * Current Spend / (1 - New Discount %))</td>
</tr>
<tr>
<td>Rate Reduction</td>
<td>Achieving a lower rate for a specific bundle of services based on insight into overall market rates and rates for specific roles and services</td>
<td>Professional services like consulting or audit</td>
<td>([Baseline Rate - Negotiated Rate]) * Current Volume</td>
</tr>
<tr>
<td>Market Basket</td>
<td>Savings measured based on achieving price reductions against a representative basket of items (used to represent a larger basket of recurring purchases, but where individual items may be too small to track individually)</td>
<td>Large baskets of low-dollar items such as office supplies or commercial print</td>
<td>Current MB Spend * (BCS % / (1 - BCS %))</td>
</tr>
</tbody>
</table>

Source: Accenture
Achieving realized savings—five key enablers

How do leaders drive realized savings and what are the critical success factors for creating a realized savings culture and capability?

**Alignment and accountability:** The first step to achieving realized savings is ensuring that there is alignment between procurement and finance on how savings will be measured and counted. Getting all key players aligned on measuring realized savings is critical to achieving the cultural shift that will help prevent savings leakage. In addition to alignment on realized savings, procurement and finance must agree on what savings methodologies will be employed, and who will be responsible and accountable for measuring and validating savings.

**Stakeholder engagement:** At this stage it is also important to seek alignment with finance on what will happen to realized savings. For example, will some, or all, of the savings in marketing spend be given back to the marketing department to redeploy, or will realized savings result in a new baseline spend level and lower budgets going forward? Our recommendation is to allow for at least a portion of savings to be reinvested in growth initiatives to help align stakeholder incentives with overall savings goals, but this is a company-specific decision. In addition, as an organization aligns on savings methodologies and accountability, it is imperative to engage stakeholders as the primary decision makers in each and every sourcing initiative and ensure that they are fully supportive of the outcomes. Engaging stakeholders in the development of policies and processes will help control spending and drive compliance. Excluding them from the beginning can result in mild resistance, such as stakeholders seeking out their own alternatives, or outright sabotage.

**Awareness and access:** Once new or revised agreements have been put in place, all stakeholders need to know how to access these agreements and operate within established policies. This involves working closely with stakeholders and suppliers to execute detailed, category-specific implementation plans. These plans will vary in design depending on the category but should involve detailed communication and training activities, as well as relevant system integration and process automation activities.

**Proactive monitoring and management at the purchase order level:** Once agreements have been put in place and fully communicated and implemented, it is crucial to establish a proactive monitoring capability to identify and stop noncompliant purchases before they are approved and executed. Some organizations use a combination of technology and purchasing specialists to both stop non-compliant orders and educate end users (who may not know they are operating outside company policies). Organizations also need to recognize that some circumstances warrant alternative suppliers and policy exceptions. It is important to determine these circumstances, set tolerances and train purchasing specialists accordingly. Even in these circumstances, specialists should capture noncompliance reason codes and determine if there are recurring supplier issues or exceptions that need to be systemically addressed to improve compliance and supplier satisfaction.

**Savings measurement and reporting:** Finally, with finance and procurement teams aligned on savings methodologies, communications and training completed, and proactive monitoring in place companies should rigorously measure spend, savings and compliance to identify opportunities for improvement. The more detailed the savings and compliance visibility, the better equipped companies will be to celebrate successes and proactively identify and mitigate issues. Detailed visibility to spend, realized savings and compliance at a category, regional and site level allows companies to pinpoint noncompliance and identify systemic issues. Further, it provides a baseline to drive continuous improvement initiatives and achieve higher levels of compliance.

**Where do I start?**

There is a lot to digest as an organization moves to a realized savings approach. Consider a phased approach: First, drive cultural alignment (steps 1 and 2 above). Second, implement process improvements and policies to drive savings realization (steps 3 and 4). Finally, drive the last mile of savings realization by tackling the most difficult areas like measurement, reporting and continuous improvement (step 5). Some organizations will have the ability to accomplish the cultural shift, process improvements and necessary infrastructure on their own. Others will need to supplement internal expertise with external expertise and resources. Regardless of the mix of internal development or external resources, the realized savings journey is well worth the effort because of the additional value that can be delivered to your organization.
Conclusion

Procurement has a strategic role to play in helping deliver realized savings, driving bottom-line financial impact and supporting the strategic goals of the business. With proper alignment between finance and procurement, organizations can increase the reliability of savings achieved and delivered to the bottom line, rather than seeing expected savings erode after sourcing and negotiation.
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