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**PURCHASING
AND SUPPLY CHAIN
MANAGEMENT**
SEVENTH EDITION



MASTER OF SCIENCE IN
BUSINESS ADMINISTRATION
Procurement & Supply Chain
Prof. Corrado Cerruti

Chapter 1


Core Concepts:
The role of purchasing in the value chain



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Learning Objectives

- The role and importance of the purchasing and supply functions in the value chain
- The difference between concepts such as ordering, buying, purchasing, procurement, sourcing, supply chain management and value chain management, and how these are interrelated.
- New developments in purchasing and supply practices of organizations.



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The role of purchasing in the value chain

Primary activities are those activities that are required to offer the company's value proposition to its customers.

Primary activities can be divided in five generic categories:

- Inbound Logistics
- Operations
- Outbound logistics
- Marketing and sales
- Services

(Porter, 1985)

The procurement function should be able to meet the material requirements related to operations management and inbound and outbound logistics.



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The role of purchasing in the value chain

Support activities are those value activities that are required to support the company's primary activities. They can be divided in four generic categories:

- Procurement
- Technology development
- Human resources management
- Facilities management (maintenance of firm's infrastructure)

This type of purchase is referred to as 'non-production buying', 'indirect purchasing' or 'general expenses'.

Procurement activities may be also related to supplying products and services for the other support functions.



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Procurement support

- Manufacturing processes can be characterised according to:
 - **Make (and distribute) to stock (MTS).**
 - **Make to order (MTO)**
 - **Engineer to order (ETO).**
- These contrasting manufacturing situations explain why procurement activities may be different between companies and industries.
- Buying for primary activities will be referred to as 'production related buying' or direct procurement.



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The role of procurement in the value chain

TABLE 1.1 Main differences between buying for primary activities and buying for support activities

Aspects	<i>Buying for primary activities</i>	<i>Buying for support activities</i>
Product assortment	Limited to large	Very large
Number of suppliers	Limited, transparent	Very large
Purchasing turnover	Very large, considerable	Limited
Number of purchase orders	Considerable	Very large
Average order size	High	Small
Control	Depends on type of production planning	Limited, forecast-related or project-related planning
Decision-making unit	Engineering, manufacturing specialists dominant	Fragmented, varies with product or service



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Definition of concepts

Purchasing:

All activities for which the company receives an invoice from outside parties.
Differentiation between:

- Purchasing function
- Purchasing department

Procurement:

All activities that are required in order to get the product from the supplier to its final destination. It is based on **“total cost of ownership-thinking”**.

Definition:

“Managing the company’s external resources in such a way that the supply of all goods, services, capabilities and knowledge which are necessary for running, maintaining and managing the company’s primary and support activities is secured at the most favorable conditions covering the materials, information and money flows up to the point of consumption”.



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Procurement function covers . .

- assessing if the company should consider make versus buy
- determining the procurement specifications (in terms of required quality and quantities) of the goods and services that need to be bought
- selecting the best possible supplier and developing procedures and routines to be able to do this
- preparing and conducting negotiations with the supplier in order to establish an agreement and to write up the legal contract
- placing the order with the selected supplier or to develop efficient purchase order and handling routines
- monitoring and control of the order to secure supply (expediting)
- follow-up and evaluation (settling claims, keeping product and supplier files up-to date, supplier rating and supplier ranking)



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Definition of concepts

Sourcing:

Finding, selecting, contracting and managing the best possible source of supply on a worldwide basis.

Procurement Management:

All activities that are required to manage supplier relationships in such a way that their activities are aligned with the company's overall business strategies and interests.

Supply Chain Management:

The management of all activities, information, knowledge and financial resources associated with the flow and transformation of goods and services up from the raw materials suppliers, component suppliers and other suppliers in such a way that the expectations of the end users of the company are being met or surpassed

Value Chain Management:

All stakeholders belonging to the same value chain are challenged to improve the (buying) company's value proposition to its final end-customers, i.e. consumers.

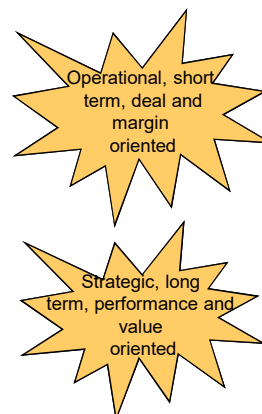


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Definition of concepts

Different definitions...

- Ordering...
- Buying...
- Purchasing...
- Procurement...
- Sourcing...
- Supply Chain Management...
- Value chain management....



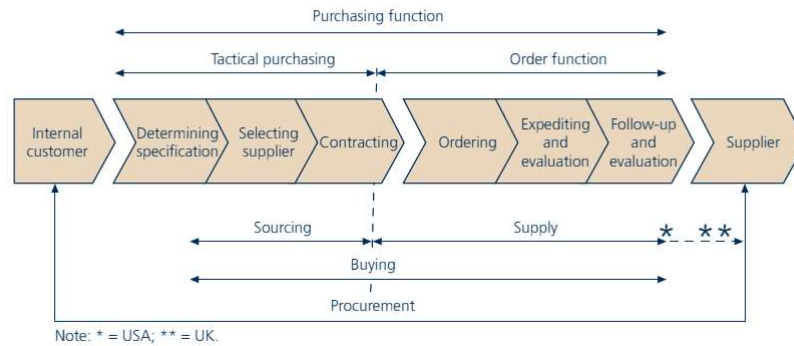
Purchasing: relates to every activity the company receives an invoice for...



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Purchasing process model

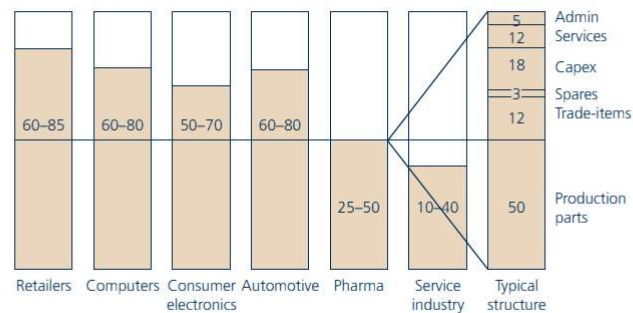
FIGURE 1.1 Purchasing process model and some related concepts



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Importance of purchasing to business

FIGURE 1.2 Purchased goods and services as a percentage of cost of goods sold

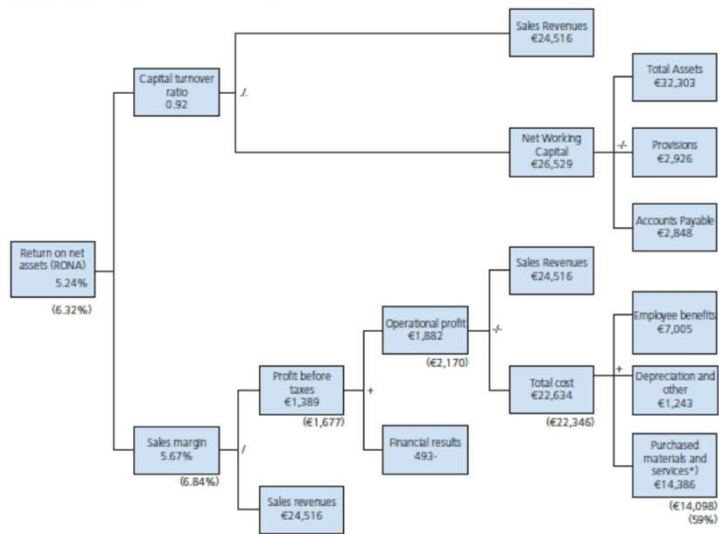


Source: adapted from Kluge (1996)



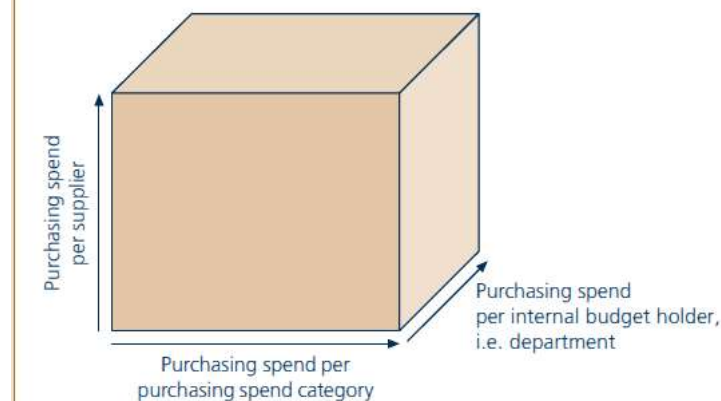
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Figure 1.3 Impact of procurement savings on Philips' Return on Net Assets (RONA)(2016, figures x 1 mio)



*) a 2% reduction of Philips' costs of purchased materials and services leads to a 20% increase of Philips' Return On Investment.

FIGURE 1.4 The purchasing spend cube



The **Spend Cube** allows us to allocate purchasing expenditure from three different angles; purchasing segments or categories, suppliers and internal budget holders or departments.

Classification of purchased goods (I)

The purchasing process may concern a large variety of goods and services. In general, purchased materials and services can be grouped into the following categories:

- **Raw materials;** materials which have undergone no transformation or a minimal transformation and which serve as the basis materials for a production process
- **Supplementary materials;** materials that are not absorbed physically in the end product
- **Semi-manufactured products;** products that have already been processed once or more times and that will be processed further at a later stage
- **Components;** manufactured goods that will not undergo additional physical changes, but which will be incorporated in a system with which there is a functional relationship by joining it with other components



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Classification of purchased goods (II)

- **Finished products;** all products which are purchased to be sold, after negligible added value, either together with other finished products and/or manufactured goods
- **Investment goods or capital equipment;** products that are not consumed immediately, but which purchasing value is depreciated over a period of time
- **Maintenance, repair and operating materials (MRO items);** materials, which are necessary for keeping the organization running in general and for the support activities in particular
- **Services;** labour intensive, non material activities that are executed by third parties on a contract basis



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Challenges and changes in purchasing's context

- **Global sourcing**
 - Components are increasingly sourced from foreign, low cost countries, a reason why large manufacturing organizations have set up International Purchasing Offices (IPOs) in different regions of the world
- **Leveraged procurement and supply strategies.**
 - In companies with several manufacturing plants, important purchasing advantages can be realized by combining common purchasing requirements.



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Challenges and changes in purchasing's context

- **Corporate social responsibility**
 - Apart from environmental issues there is a growing pressure from the public that products should be clean, and originate from countries with free trade.
- **Resource scarcity**
 - This poses new challenges towards purchasing professionals who need to develop a much more forward outlook on how to secure the company's future requirements for critical materials and products.



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Challenges & changes in purchasing's context

- **Supplier integration**
 - An integrated approach of materials management requires close cooperation between production planning, inventory control, quality inspection and purchasing.
- **Early supplier involvement**
 - As more and more innovations in industry come from suppliers, getting them involved early in the new product development process becomes an issue of prime concern.



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Summary

- Purchasing and supply chain management has developed into a key business drivers. Its purpose is to develop a competitive, world-class supply base for the company.
- Purchasing encompasses everything for which the company receives an invoice. Traditionally direct purchasing has received the most attention but this is changing.
- The most important the new challenges will be global sourcing, the need to develop leveraged purchasing and supply strategies, integration of suppliers in both materials and new product development processes, reciprocal arrangements, and socially responsible purchasing.



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