

**Should Labour
services be
categorised as
Indirect spend?**

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JigsawSEARCH

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A lot of time is spent by CPO's discussing the high level structure of a procurement framework but little time seems to be devoted to the categorisation of spend, especially with regards to how critical that spend may be to the ongoing success of the organisation. Procurement as a function has spent so long attempting to distance itself from buying, could it be possible it has actually forgotten one of the primary reasons it exists? Which is to understand what motivates the buying decision and how critical those motivations are to the ongoing competitiveness of the business.

One of the fundamental acquisitions for any business is Labour. Contained within all the position briefs and position descriptions we receive at Jigsaw Search, there is plenty of emphasis placed on process, influencing, risk and savings, but very little on the detail relating to procurement categories and more importantly the defining of these categories. In reality this business oversight could be a main cause of failure for the procurement function within a business.

Standard examples of Indirect Spend

Travel, Labour, Marketing, Catering, Technology, Uniforms, Capital Works, MRO, Waste, Cleaning Products.

Indirect Spend Definitions

1. Indirect spend is the cost of services or products that are not critical to the business' i.e. do not create or protect a barrier to entry. They have little impact on the business' ability to beat its direct competitors and hence are indirectly related to business success. To further this point it would be possible in theory for two FMCG businesses that compete in similar markets to leverage and consolidate their indirect spend contracts (through buying groups and consortiums) without giving away market share.
2. Indirect spend can be a group of costs that do not contribute to the final offering to the customer such as a finished good. As a result the indirect costs have little impact on the cost to serve per unit to the customer and cannot give a market edge in pricing or profitability on a particular product.
3. Indirect spend is embodied as corporate services and includes all facets of shared services by the business such as Marketing, HR, Travel and Fleet.

The indirect spend definitions above are all commonly used, but lead to very different category strategies and effect how procurement is perceived from a commercial awareness perspective within a business.

Using these definitions could lead to the following two scenarios for a procurement department:

1. Procurement has diagnosed categories of spend with relevance to industry, product offering and customers that effect front-end revenue generation and cost cutting to improve bottom line profit. Full categorisation of direct/indirect/critical & non-critical have been used.
2. Procurement has diagnosed categories of spend with relevance to product offering without questioning the products and offerings of the business or the industry sector relevance using a simple direct/indirect categorisation.

Standard examples of Direct Spend

Commodities, Packaging, Capital Works, Chemicals, Finished Goods, Ingredients

Direct Spend Definition

1. Direct Spend is cost attributed to the final product that is sold onto the customer.
2. Direct spend is a group of spend categories that are directly relevant to a particular business and hence have a direct impact on market positioning against direct competitors.

As can be seen from the previous examples of direct and indirect spend, there are grey areas that can be hard to differentiate. This is because whether a service or product is direct or indirect is completely dependent on the business and its offering to a given market.

For example, it is rare that technology would give a global FMCG business any advantage over its competitors in terms of the quality of finished goods, but for a bank, technology is directly related to the offering it can provide to the customer which in turn can increase its market share.

A given product or service could be both direct and indirect depending on its functionality, complexity and exclusivity. For instance, as a rule technology is commonly viewed as indirect to an FMCG business, but if the FMCG business captured a piece of technology that enabled it to channel products to a new market beyond that of its competitors, then this could be viewed as direct.

It is complexities such as these that require further terminology to help differentiate cost further across the broad range of services and products available to businesses.

The diagram below illustrates an example of how the first phase of a category strategy for Labour could be better assessed. Of course not all cost centres are incorporated, but the example gives a flavour of the typical thinking and approach businesses are currently using.

The diagram effectively shows that there are no items categorised as direct and non-critical and only a handful are indirect non-critical. In reality almost all items have a level of criticality, what differs is how critical each item is depending on business function and the industry in which the company operates.

Employee Criticality Matrix

Key:
Business Function/Roles Industry

Direct ▶				Direct ▶						
◀ Non-critical					R&D	IT	Marketing	Supply Chain	CEO	Critical ▶
					M'facturing	Finance	Finance	FMCG	Finance	
◀ Non-critical					FMCG	Services	Mining	FMCG	Mining	
					Retail		FMCG	M'facturing	FMCG	
							Consulting	Retail	Consulting	
							M'facturing		M'facturing	
							Construction		Construction	
							Services		Services	
							Retail		Retail	
				Legal	IT	Finance	Supply Chain	HR	Critical ▶	
				Finance	Finance	Finance	Finance	Finance		
				Mining	Services	Mining	Mining	Mining		
Clerical	Admin	Call Centre	Cleaner	FMCG		FMCG	Construction	FMCG		
Drivers	Shelf Stackers	Mailroom	Reception Staff	Consulting		Consulting	Services	Consulting		
				M'facturing		M'facturing		M'facturing		
				Construction		Construction		Construction		
				Services		Services		Services		
				◀ Indirect					◀ Indirect	

Critical and Non-Critical Spend

Critical in this instance means operationally critical either from the perspective of producing products and services or being able to service customers. By integrating the terms critical and non-critical in addition to the more mainstream labels direct and indirect, we can broaden the definitions to accurately represent the point where a category transcends from non-critical to critical enabling layered procurement strategies within an organisation to match the needs of the business.

By combining the two sets of terminology, Technology for example within the FMCG industry can now be labelled indirect/critical.

Although it has no direct impact on market positioning and final product offerings, it is an operationally critical function that enables cross functional communication, data management and e-solutions. Stationery is an example of indirect/non-critical. It is both low-level in terms of cost and non-critical to either the business or the operating stakeholders employed.

By using a combination of these terminologies and more importantly by thinking of categories in this matrix format, procurement practitioners can categorise a service or product range in a way that gives them a greater understanding of how a portfolio of spend could effect more than just the bottom line and can adjust its sourcing strategies accordingly.

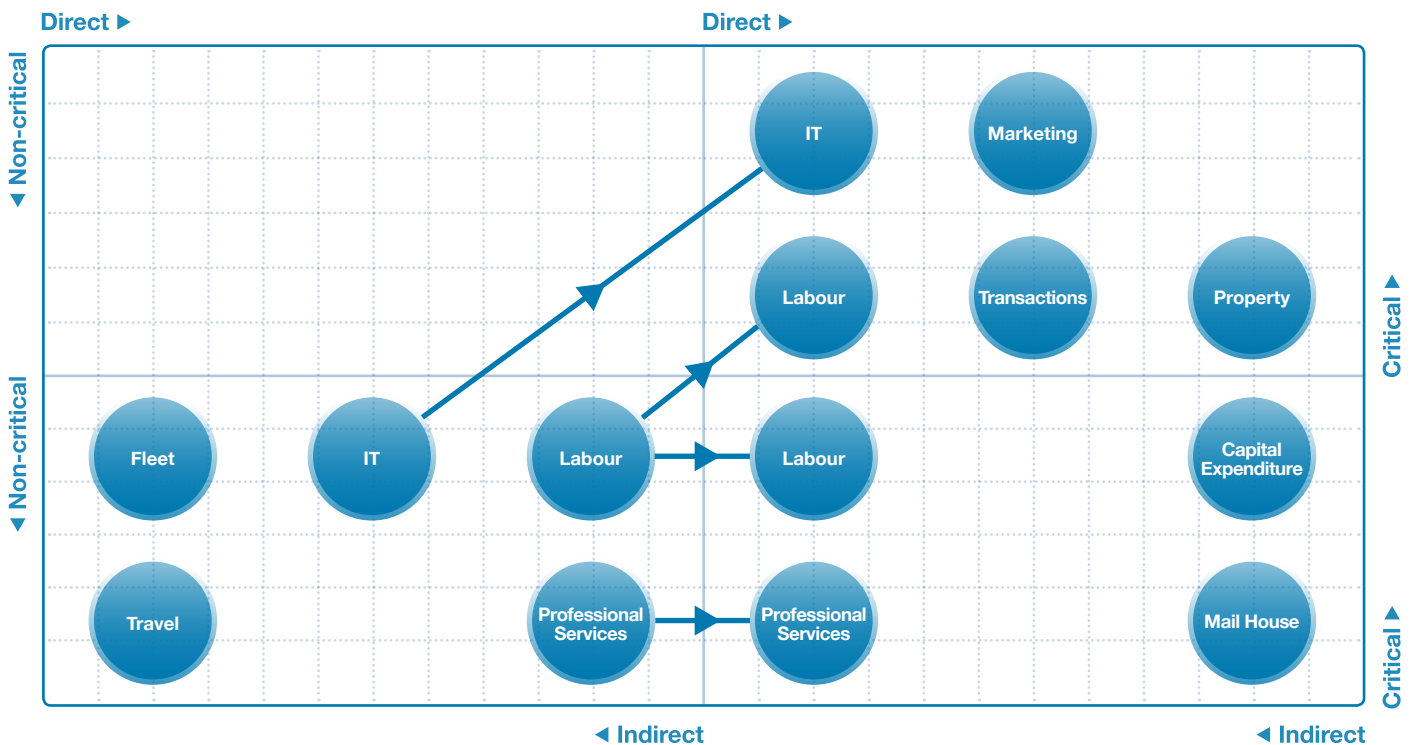
The diagram below outlines category complexity within a **Finance** business.

Categories have varying degrees of business impact, one of the few categories that is unique to every single organisation is Labour, often lauded by CEO's in their annual reports as 'the most important spend in our business'. In the example below, labour along with IT appears in multiple segments of the diagram. It shows the different ways in which it could be viewed from a spend perspective depending on the circumstances of the particular Financial Services business and where the labour or IT needs acquiring.

Categories that appear in the direct and critical segment are essential in relation to business performance, revenue generation and innovation. Price should not be the major factor when sourcing strategies are put in place.

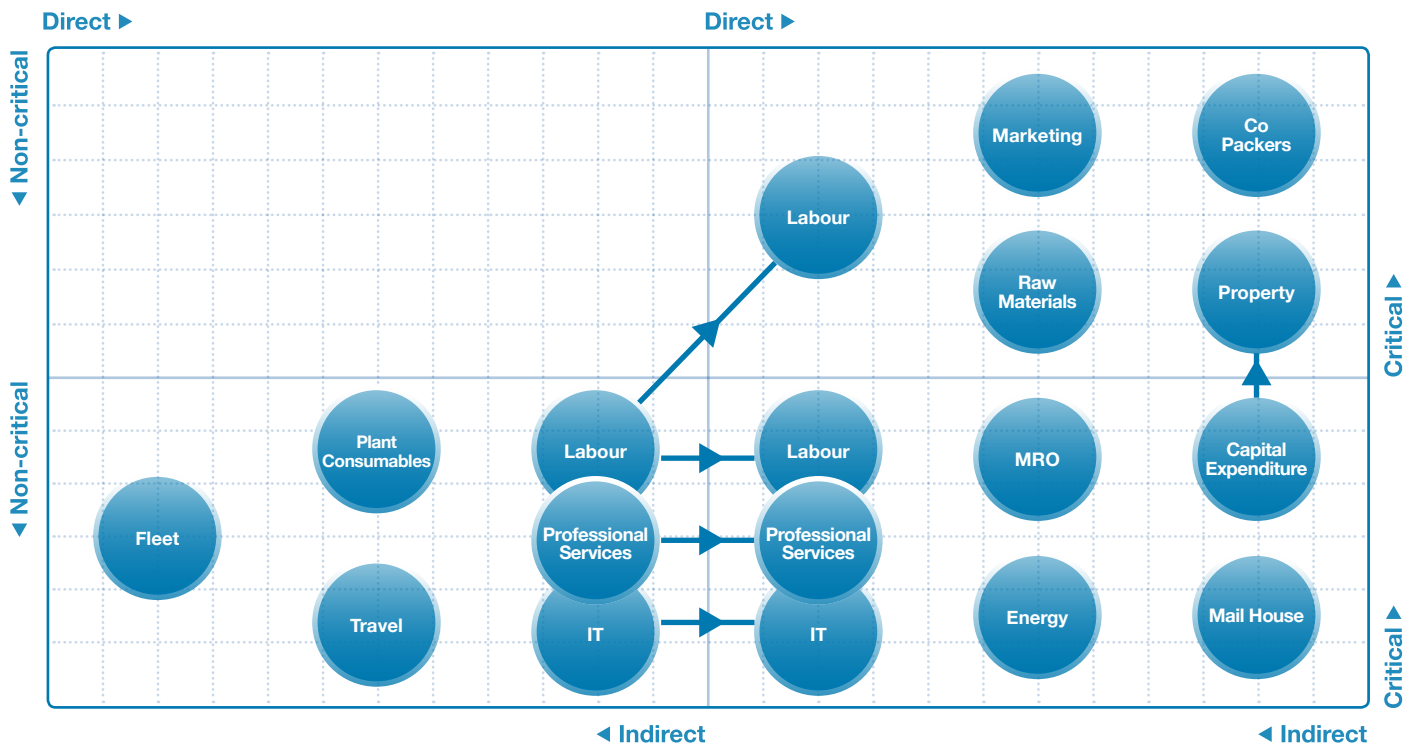
Only in the non-critical and indirect segment should procurement strategies focus on 'the size of the prize' as a priority factor.

Example of procurement category's criticality within a Financial Services business



In these FMCG and Retail examples below, Labour again seems to be the only category that transcends 3 areas of spectrum.

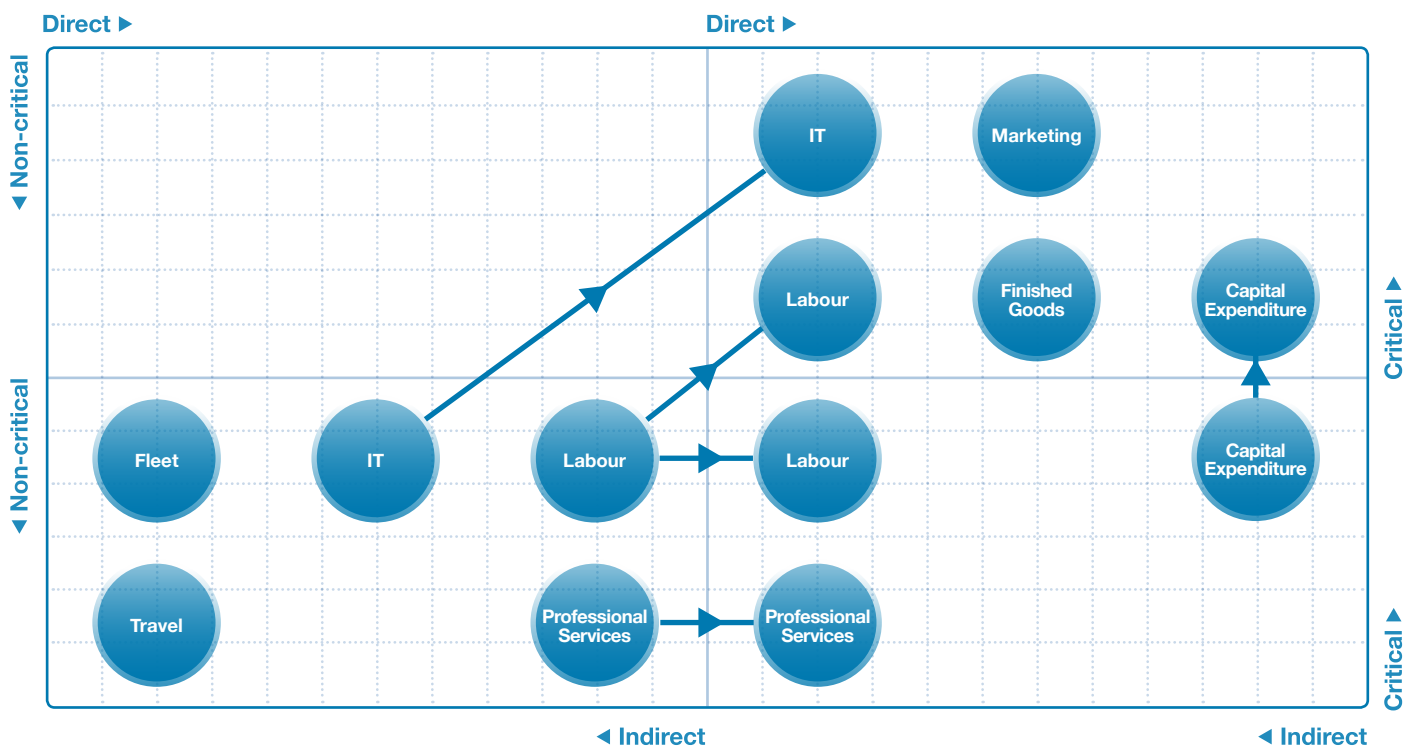
Example of procurement category's criticality within a FMCG business



Categories that appear in the direct and critical segment are essential to business performance, revenue generation and innovation. Therefore, price is not the key sourcing driver and should have a lower priority when sourcing strategies are put in place.

From a purely commercial perspective, only in the non-critical and indirect segment should procurement strategy focus on transactional cost reductions as a priority.

Example of procurement category's criticality within a Retail business



When Labour is a Direct Category

In nearly every company Labour is categorised as indirect spend – unless, using the definitions discussed before, a business sells Labour i.e. consultancies and On-hire agencies.

The strategies employed to manage Labour categories have been developed mainly because companies have seen little differentiation in delivery between recruitment agencies, or have a lack of understanding of the differentiators.

Either way, the reality is recruitment providers are seen as a necessary costly evil of obtaining professionals from the labour market. The view is that most recruitment providers offer the same basic pricing, attraction strategies, administrative capability, reporting and geographical footprint.

The real problem is that most recruitment businesses are offering a commoditised service with little differentiation in approach, but the product they are providing (i.e. a person) is not commoditised. All people are unique and have different (albeit sometimes similar) technical and cultural, skills and experiences.

Buying from Brokers

What makes Labour a very difficult category to manage is the fact that Labour providers are only brokers and therefore have no influence over the quality, volume, availability or price of the products they provide. In most areas where procurement influences the commercials and control of goods and service supply, the contract is set with a supplier that has actual influence on the outcome. The contract is either direct to source or direct to the provider of the source.

For example

- **Travel** – Procurement (demand) – Supplier (business owns planes and the service)
- **Widgets** – Procurement (demand) – contract – Supply (business makes the widgets)
- **Marketing** – Procurement (demand) – contract - Supply (business owns IP and ideas)
- **Cleaning** – Procurement (demand) – contract – Supply (business owns staff and cleaning agents)
- **Packaging** – Procurement (demand) – contract – Supply (business procures commodity)

So although Labour is different and a more complex category; the sourcing and contractual engagement is often exactly the same as when engaging products directly from a supplier.

The most common strategy used by businesses with a Labour need, invariably involves a request for a standardised service sourced through a pre-defined and electronic tender process, followed by a pre-used formulaic contract that locks in a service provider (single or multiple) to deliver pre-defined (or at least pre- envisaged) professionals. However, the problem with all of this is that the contract is not executed with the source of the product or with the provider of the source of the product.

No recruitment firm can guarantee supply of professionals and hence it cannot control either the commodity (people) or the delivery of the service that accompanies it.

Different elements of Labour need to be categorised depending on how critical the elements are to the business and appropriate sourcing strategies applied.

