



UNIT-2

Purchasing and Procurement Basics

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Differentiate between Purchasing and Procurement
- ✓ Explore the Importance, Aims and Organization of Procurement.

Unit 2

Purchasing and Procurement Basics

Purchasing and Procurement

As we have previously discussed, the preparation of a supply chain begins with strategic objectives, moves down to systematize the movement of materials, ensures that resources are obtainable and constantly looks for areas for improvement. But we have still not discussed the method for initiating the movement of materials. This is facilitated by **Purchasing** or **Procurement**.

In a supply chain, every business purchases materials from suppliers, adds value and sells them to downstream consumers. As every business in turn buys and sells, the materials flow through the entire supply chain. The trigger that begins each move is a **Purchase**. This is primarily a message that a business sends to a seller, something along the lines of, “we have agreed on terms, so deliver the materials to us and we will pay you”.

PURCHASING provides a system for initiating and regulating the flow of materials all over the supply chain.

Purchasing is the task that takes responsibility for acquiring all the materials requisite by an organisation. Many of the purchaser's transactions are not standard, but comprised of rental, contracting, leasing, gifts, exchange, borrowing and so on. This is the reason why some people talk about the 'achievement of materials' or the more common term of **Procurement**. 'Procurement' and 'purchasing' are often referred to as the same thing. Usually, purchasing refers to the actual buying process, while procurement has a much wider meaning. It can consist of different kinds of acquisition (rental, purchasing, contracting and so on) as well as the related work of selecting suppliers, agreeing terms, negotiating, expediting, monitoring supplier performance, materials handling, transport, warehousing and receiving goods from suppliers.

PROCUREMENT takes care of all the materials required by a business. It consists of all the associated activities required to get the goods, services and any other materials from suppliers to the business.

Procurement does not generally involve the movement of materials, but it *arranges* the transfer. It communicates the message that materials are required and organises the change of possession and location. But it is another function, like transport, that really delivers them. So, procurement is mainly concerned with information processing; it gathers data from a range of sources, analyses it and conveys the information to the supply chain.

Importance of Procurement

It is easy to see why procurement is vital. If we take a wider view, procurement forms a necessary connection between businesses in the supply chain and provides a system for coordinating the movement of materials between suppliers and consumers. At each point in the supply chain,

procurement sends messages backwards to explain what customers desire in a product; it also passes messages forwards to declare what suppliers have accessible. Then it negotiates conditions for delivery.

If we take a more limited view, procurement is clearly an essential function within every organisation. We know that each organisation requires some supply of materials and procurement is responsible for organising this.

If procurement is carried out badly, materials do not arrive, or the wrong materials are delivered in the wrong quantities, at the wrong time, with poor quality, at too high price, with poor customer service and so on.

Aims of Procurement

The overall objective of procurement is to assure that a business has a consistent supply of materials. With this superseding aim, we can widen scope with the following list of more direct goals:

- organising a consistent and continuous flow of materials into a business;
- working directly with end-user departments, establishing relationships and understanding their requirements;
- finding good suppliers, working directly with them and developing beneficial relationships;
- buying the correct materials and ensuring that they have satisfactory quality, arrive at the time and place required and meet any other needs;
- negotiating the best prices and all other terms and conditions;
- keeping stock low, considering stock policies, investment, readily available materials and so on;
- moving materials rapidly through the supply chain or expediting deliveries when essential;
- Keeping abreast of conditions, including pending price increments, shortages, new products and so on.

Organisation of Procurement

The way that procurement is controlled always depends upon the kind and size of the business. In a small organisation, a single consumer might be accountable for all purchases, policy and supervision. A medium-sized organisation might have a department with buyers, storekeepers, expeditors and clerks. A big company might have hundreds of people co-ordinating large volumes of purchases.

Usually, procurement is arranged as a single division to gain the advantages of **centralised purchasing**.

These benefits include:

- Consolidation of all orders for the same and similar materials to acquire quantity discounts
- Co-ordinating related activities to decrease costs of transport, stockholding and administration
- Eliminating duplicated efforts and messy practices
- Having a single point of contact for vendors and giving them reliable information and service
- Developing focused skills and enhancing procurement operations
- Allowing other people to focus on their own work without having to think about purchasing
- Concentrating liability for procurement and making management organization easier

Choosing Suppliers

Qualified Suppliers

Arguably, the most significant element of procurement is finding and choosing the right supplier. There is no point in having an outstanding product if the supplier cannot be relied on to deliver it. Suppose you are working on a plan and need to purchase significant materials – maybe a prefabricated bridge for a building project. You will consider two factors. First, a product design that meets your needs and second, a seller who can promise to deliver the product as required. In other words, the seller must be capable of doing the work, delivering high quality service, working to a timetable, promising satisfactory costs and so on. An advertised time of four hours for a train journey may appear to be good service, but it has less value if the train operator cannot actually deliver this.

Procurement begins by finding a **capable supplier**. This means a supplier who can absolutely deliver the materials required.

In general, organisations search for suppliers which:

- Are financially safe with good long-standing prospects;
- Have the aptitude and competence to supply the essential materials;
- Accurately deliver the requested materials;
- Send materials that are high in quality;
- Deliver reliably, on time and with minimal lead times;
- Quote satisfactory prices and financing arrangements;
- Are flexible to customers' demands and changes;
- Are knowledgeable and have expertise/experience with their products;
- Have earned an excellent reputation;
- Use expedient and simple procurement systems

- Have been used effectively in the past and can nurture long-term relationships

In diverse circumstances, a lot of other factors may be significant, like convenient location, skill to deal with variable demand and so on.

Most organisations maintain lists of officially-approved suppliers who have given good service in the past, or who are otherwise known to be trustworthy. If there is no satisfactory supplier on file, the organisation has to search for one. Suppliers for low-value items can sometimes be found in trade journals, catalogues or through business contacts. More costly items need a careful search and selection process, which can be very time-consuming.

A helpful approach for deciding on the best supplier for a product includes the following steps:

- Look for alternative suppliers;
- Build a list of qualified suppliers who can deliver the products;
- Compare organisations on this long list and eliminate those which are, for any reason, less desirable;
- Continue eliminating organisations until you have a shortlist (usually four or five) of the most promising suppliers;
- Prepare an enquiry or request a quotation and send it to each of the suppliers;
- Receive bids from the shortlist;
- Do a preliminary evaluation of the bids and eliminate those with major problems;
- Do a technical evaluation to see if the products meet all specifications;
- Do a commercial evaluation to compare all costs and other conditions;
- Arrange a pre-award meeting to discuss bids with the remaining suppliers;
- Discuss bid conditions, which are specific conditions that have to be agreed upon by both parties;
- Select the supplier which is most likely to win the order;
- Arrange a pre-commitment meeting to sort out any last minute details;
- Award orders to the preferred supplier.

This is clearly a time-consuming procedure, but keep in mind that a poor merchant can cause more problem than simply providing poor materials. Remember: this whole process is utilized for main purchases only. If you are simply looking to buy pencils or basic supplies, for example, the shop next door is possibly as good as any other supplier.

Normally, a business will not spend a lot of time looking at substitute suppliers if:

- It is purchasing low-value materials;
- There is just one supplier available;
- There is already a successful arrangement with a merchant;
- There is not sufficient time for extensive negotiations;

- The business has a strategy for selecting particular types of supplier.

Sometimes, specifically with government work, procurement has to be comprehensively fair and all prospective suppliers must be provided with the chance to give quotations. Rather than making a shortlist of capable suppliers, a business will broadly promote that it is seeking quotations for particular materials or work. The organisation evaluates all the bids submitted and selects the one that best fulfils the approved criteria. This is called **open tender**. A difference reduces the managerial effort by putting some qualifications on suppliers, maybe based on experience, financial status, or size. This gives a **limited tender**.

As you can see, we are discussing how consumers select suppliers – and we are supposing that suppliers are pleased to serve all the consumers they can attract. This is generally the case, but often suppliers have more authority and selectiveness when selecting their customers. This might occur when a supplier enjoys a monopoly, or near-monopoly, of some material or product. It may also occur when there is a short-term shortage of some product, such as oil, and suppliers select the customers they will sell to - maybe giving first choice to larger consumers, those who pay more or those who have long-standing agreements.

Number of Suppliers

We have already talked about the trend towards building partnerships and alliances. This unavoidably moves businesses towards single or limited suppliers, either for every material or for a range of diverse materials. Some organisations refer to this as **single sourcing**, which leaves them vulnerable to the performance of an individual business; all of which can lead to serious problems if anything goes wrong along the way. If the single seller of a vital part hits financial difficulties, an organisation though no fault of its own might have to halt production. To avoid this, some organizations employ a strategy of buying the same materials from more than one competing supplier. They may use rules of thumb such as ‘never let a producer account for more than 20% of total revenue’ or ‘never let a consumer take more than 50% of total resources’. The selection must depend on individual circumstances, there are certainly benefits to both policies:

Benefits of single sourcing:

- A stronger connection between consumers and suppliers who may form valuable alliances or partnerships;
- Dedication of all parties to the accomplishment of the relationship;
- Economies of scale and cost discounts with large orders;
- Easier communication, decreased administration and simpler processes for standard orders;
- More consistency in materials and their supply;
- Easier to maintain requirements, terms, conditions, and so on.

Benefits of multi-sourcing:

- Competition between suppliers decreases prices;
- There is less possibility of disrupted supply, as issues can be avoided by changing suppliers;
- Can deal and easier with changing demand;
- Involving more businesses can provide access to broader information and knowledge;
- More probable to benefit from innovation and development;
- Does not rely on trusting one single organisation.

Organizations utilize more sellers when they want to avoid potential problems. Another way of doing this is an approach called **forward buying**. In its simplest form, this occurs when a business orders more materials than it presently needs and keeps the surplus in stock.

Another form utilizes contracts to bring materials at particular points in the future. Both of these carry two benefits. Firstly, they assure supplies for some period in the future and reduce the effect of potential disruptions. Secondly, the cost of the materials is fixed, avoiding the possibility of future price increases or unavailable items. Of course, things can still go wrong. A company that signs a long-term contract can still go out of business, or a storage facility can burn down. Nevertheless, the chances of facing a crisis are much lower. It is perhaps safest for the business to hold spare stock itself, but this has higher costs. By contrast, agreeing a contract for upcoming deliveries gives lower costs, but does not eliminate so much risk.

Monitoring Supplier Performance

Most organisations monitor their suppliers to ensure that they continue providing satisfactory service. This is called **Supplier Rating** or **Vendor Rating**. This is usually done casually by way of a skewed review; sometimes there are multifaceted measures for each element of performance. Most organisations employ a negotiation process that gives a sensible view of performance, and requires a rational amount of effort. One general approach utilizes a checklist of significant factors and checks that the supplier meets a suitable standard in these. The checklist may ask whether the supplier is economically sound; whether its supplies on time; if material value is high enough; if there is practical support; whether the cost is competitive; is able to offer advice and support about related trends and so on.

If the supplier does not meet any of the required measures, the consumer has to demand improvements or look for new sources. The objective is not specifically to substitute particular suppliers on a regular, but to check performance, recognize areas that require improving and agree on the very best way of making these improvements. Only as a last option should a business start looking for new suppliers.

A more practical approach gives the seller a score for diverse aspects of performance. They may, for instance, give each supplier a score out of ten for on-time delivery, and if a supplier's score drifts down below eight, the consumer can consider ways of improving performance. Although this method sounds simple, it can present substantial difficulties. How, for instance, can you recognize the most significant factors of supplier performance, the comparative value of each, the actual performance and the lowest acceptable performance?

Each of these is likely to come from a blend of agreement and discussion, rather than from more accurate measurement. The result is a skewed view that might be useful, but contains little objective and concrete measurement.

Procurement Cycle

Steps in the Cycle

After selecting the supplier, the business has to follow a series of processes for arranging purchases. Suppose that you want to purchase something costly, like a new computer. You possibly approach this in a number of stages; listing the features you want, searching for systems that may provide these, searching suppliers, developing a list of options, comparing these and selecting the best option. Your objective is to find the blend of products and suppliers that best caters your needs. The procurement function in a business does exactly the same, following a particular process for every purchase. This process is diverse in each organisation and varies with the kind of items being bought. You would not anticipate an organisation such as the US army, which purchases millions of items a day, to work in the same way as the directors of Real Madrid football club when they look for a new striker. And the US army would not approach its decision to purchase pencils in the same way as its decision to purchase helicopters.

Despite these inherent differences in detail, we can nonetheless propose a common approach to procurement. This involves a chain of common steps, which begin with the user searching for required materials and ends when the supplies are delivered.

A distinctive **Procurement Cycle** has the following steps (with key documents in bold) -

1. A user department:

- Ñ Establishes the need for acquired materials;
- Ñ Examines materials accessible and prepares **specifications**;
- Ñ Checks departmental financial plans and gets clearance to procure;
- Ñ Prepares and transmits a **purchase request** to procurement department.

2. The procurement department:

- Ñ Obtains, verifies and authorises the purchase request;
- Ñ Inspects the material requested, looking at existing stocks, substitute products, production options and so on. After negotiations with the user department, procurement makes a shortlist of possible suppliers from standard suppliers, lists of favoured suppliers or those known to cater to requirements;
- Ñ Sends a request for quotations to this shortlisted suppliers.

3. Then, every supplier:

- Ñ Examines the requests for quotations;
- Ñ Checks the customer's position, status, credit and so on;
- Ñ Considers how it could best cater the order;
- Ñ Sends a quotation back to the business, giving details of prices, products and conditions.

4. Then, procurement:

- Ñ Examines the quotations and carries out commercial evaluations;
- Ñ Discusses the technical aspects with the user department;
- Ñ Checks the budget details and clearance to purchase;
- Ñ Chooses the best supplier, based on the supplied details;
- Ñ Discusses, consults and confirms the terms and conditions with the seller;
- Ñ Issues a purchase order for the materials (with terms and conditions attached).

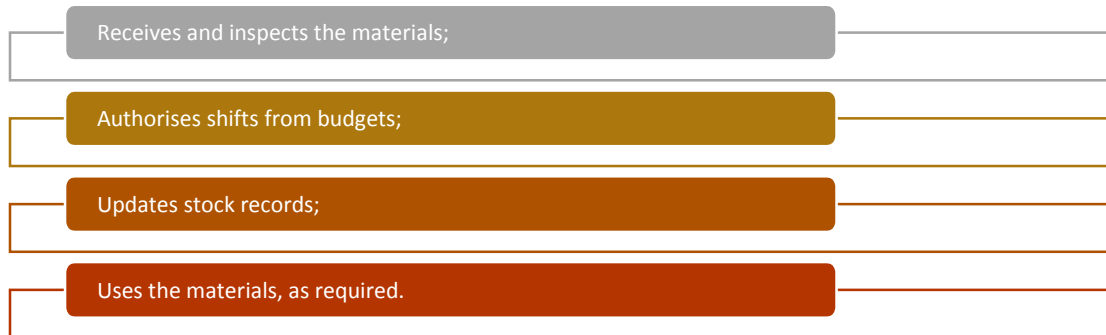
5. The selected supplier:

- Ñ Receives, acknowledges and processes the buying order;
- Ñ Organises all operations required to provide the materials;
- Ñ Ships materials jointly with shipping advice;
- Ñ Sends an invoice.

6. The procurement department :

- Ñ Acknowledges the receipt of materials;
- Ñ Carries out necessary follow-ups and requests information where required;
- Ñ Receives, examines and accepts the materials;
- Ñ Informs the user department of materials received.

7. The user department:



8. The Procurement:

Arranges for the payment of the supplier's invoice.

The first three steps are more concerned with the supplier and materials, and then comes the critical point with the topic of a purchase order in step 4. At this stage, the organisation has decided it is willing to buy particular materials from a supplier, and the purchase order triggers the supply process (along with essential production planning, transport arrangements, finance and so on). The purchase order is one element of a legal agreement between the supplier and its customer. The remaining steps focus on the details of delivery.

This process seems complicated and consists of a lot of steps and documents. If you are buying something costly, the effort is definitely worthwhile. You might in fact follow a much more complex procedure to set product specifications, choose the supplier and discuss terms. But if you are making smaller purchases, if there are existing relationships with suppliers or there is just one competent supplier available, it is generally not worth going through this lengthy and expensive procedure.

Some of the issues with paper-based procurement are:

- It takes too much time to go through the entire procedure;
- Relies upon heavy paperwork, which is passed between various locations;
- Labour required to complete, examine, process, store and generally deal with all the papers;
- Has other people administer, manage and organize the managerial procedures;
- Inevitable errors may arise because of too many documents and people involved;
- Not able to interact with linked systems like stock control.

A pivotal step in the evolution of procurement came with electronic buying. Electronic Data Interchange (EDI) has been utilized since the 1980s and permits automated procurement. A business links its information system to a vendor's and when it is time to place an order, the system automatically conveys a message. This works well for small, normal and repeat orders and most businesses quickly adopted the method. There are some variations on automatic procurement, all of which are categorised under the broad heading of **e-procurement**.

E-Procurement

Most organisations are currently utilizing some type of e-procurement. Surveys suggest that more than 60% of UK companies were using e-procurement by 2002 and 80% of European managers are already using the system or intend to implement it in the near future.

Some of the benefits this system offers include:

- Allows immediate access to vendors anywhere in the world;
- Creates a transparent market where goods and buying terms are readily accessible;
- The automation of procurement with benchmark procedures;
- Greatly reduces the time required for transactions;
- Reduces costs, usually by 12–15%;
- Allows some procurement activities to be passed vendors or third parties;
- Integrates flawlessly with suppliers' information systems.

There are essentially two kinds of e-procurement which are explained as B2B (where one company buys materials from another company) and B2C (when an end customer buys from a business). Most of the people are more familiar with B2C transactions.

Between 1999 and 2002, the number of Internet shoppers in the UK increased from 2 million to 6 million. Nonetheless, many of these websites hit monetary troubles with the bursting of the 'dot-com bubble' and there have been plenty of extensively publicised bankruptcies.

One difficulty, of course, is that people do not essentially like e-procurement. If you want to purchase a book, you can visit a variety of websites, fill in the forms and get the book delivered within a day. But if you go to your nearby bookshop, you may use less advanced and convenient technology, but you get to pick up the book right away and with no delivery charge. B2C can run also into difficulties as people in general like going to look at things they are thinking of purchasing before they purchase them.

Further Reading:

- ✓ *Caroline Booth, (2010), Strategic Procurement: Organising Suppliers and Supply Chains for competitive advantage*
- ✓ *Jeffrey P. Wincel, (2004), Lean Supply Chain Management: A Handbook for Strategic Procurement*
- ✓ *Robert W. Turner, (2011), Supply Management and Procurement: From the Basics to Best-in-class*