



Directworks™

Direct Materials Sourcing, Streamlined.

Manufacturer's Guide for Improving Visibility into Total Costs

This guide presents a proven five-step framework for improving visibility into a supplier's bids regarding direct materials sourcing. By adopting such best practices, manufacturers gain insights into suppliers that enable them to make the best sourcing decision. A case study featuring Whirlpool Corporation is included.

Total Cost Visibility: The Key to Strategic Sourcing Success

Among manufacturers, total cost visibility is the holy grail of direct materials sourcing. It is recognized as the number one improvement opportunity for strategic sourcing and supply chain professionals across the manufacturing industry (Survey of 400 sourcing professionals, 2013). Total cost visibility is a complex challenge, yet one that can be mastered when you properly align people, process, and technology.

Manufacturers agree that a clear understanding of total cost provides a competitive advantage. Such insight leads to higher margins, more successful new product introductions, and more stable supplier relationships. Best-in-class manufacturers leverage a deeper understanding of total cost to negotiate the optimal price for guaranteed capacity, lower supplier risk, and the right level of quality. In short, improving total cost visibility leads to better sourcing decisions.

So where should you start if you want to improve visibility into total cost? The following is a proven framework.

Framework for Improving Total Cost Visibility



Step 1 of improving visibility into total cost is to define the concept and to identify the discrete elements that contribute to total cost. We define total cost as:

$$\text{Total Cost} = \text{Component Costs} + \text{Transit Costs} + \text{Finance Costs} + \text{Compliance Costs} + \text{Cost of Poor Quality}$$

A discussion of each of these elements follows.

Component costs

For many manufacturers, component costs account for a significant portion of total cost. One of the most critical steps of enhancing visibility is to make sure suppliers provide detailed breakdowns of component costs. The more a supplier aggregates, the more likely they may be trying to hide additional margin. Careful examination of this area can pay big dividends during negotiations. Also be sure to ask for clarity around component costs tied to commodity indices or other market factors. And don't be afraid to ask the supplier to spell out their profit margin. If they are seeking to establish a true win/win relationship, they will be willing to share this information.

- Materials
- Labor / burden
- Production
- Tooling & setup
- Scrap
- Packaging
- Prototypes
- SG&A
- Supplier profit

Transit costs

Costs associated with getting the components into your plant can vary greatly from supplier to supplier. A supplier on the other side of the globe may have a cheaper piece price, but when you factor in the expense of bringing the parts to your plant, they may actually cost more. One of the interesting aspects of transit is that you have the ability to make your own shipping arrangements, shifting the cost from the supplier to another party. Best-in-class manufacturers can often secure more favorable pricing when they drive the terms with transportation companies and the other 3rd parties involved along the way.

- Freight / shipping
- Customs, duties, tariffs
- Drayage
- Agent fees
- Consolidation fees
- Shrinkage

Finance costs

You usually need help from finance to determine the impact of these factors on cost. These can include working capital costs related to the amount of inventory you need to carry based on the lead time associated with the suppliers you choose, as well as factoring in the strength of the dollar. Best-in-class manufacturers have discovered that finance costs can be critical to the final decision of which suppliers to select, as well as playing a more important role in strategic decisions regarding make vs. buy, re-shoring, etc.

- Payment terms
- Foreign exchange fees
- Currency exchange gains & losses
- Inventory carrying costs
- Financing fees
- Insurance

Compliance costs

These are costs that are generated due to efforts to conform to government legislation or regulation. Such expenses often include headcount hired specifically for compliance activities, costs associated with data collection and reporting, and any fines that resulted from compliance issues. Conflict minerals is the latest regulatory event grabbing manufacturers' attention. Others include ITAR, REACH, RoHS, and carbon or sustainability reporting.

- Regulatory reporting expenses
- Legal fees
- Fines

Cost of poor quality (COPQ)

In Six Sigma terms, the cost of poor quality is equal to the cost of internal failures plus the cost of external failures. COPQ can be a critical piece of the puzzle as it may be better to spend more on better quality components rather than to have to cover COPQ costs. Note that the cost components (e.g., warranty claims, inspection, etc.) do not include lost sales, lost customers, reputation damage, and brand erosion. It isn't just the product P&L that may suffer, but the top line of the company as well.

- Warranty claims
- Inspection
- Rework
- Returns
- Allowance
- Administration costs

Step 2 involves developing a roadmap to collect the detailed cost information for any given sourcing project. We have no delusions that data collection will be an easy task. You are dealing with numerous suppliers and third-parties, as well as multiple internal departments and systems. Your roadmap will be implemented in phases over time. One key to success is determining which factors you need to focus on first in order to help improve your near-term decision making. The priorities can be different from manufacturer to manufacturer. Some may not have involved their finance department to understand inventory and working capital costs. Others are not collecting enough detailed information from suppliers. Roadmap development should not be done in a vacuum. Create a cross-functional team of engineering, sourcing, logistics, finance, etc.

Step 3 consists of building a complete total cost template that incorporates the five categories of cost we discussed in Step 1. Because of the detail required in the final template, we suggest you proceed in two steps. First, create a simple template that will be used during the first round of the quoting process to assess supplier competitiveness. Then narrow the list of suppliers and complete the quoting process with the detailed total cost template.

The detailed template should be segmented into fields that the supplier will complete (e.g., component, transit, etc.) and fields that you will primarily complete (e.g., finance, compliance, COPQ costs). In some cases you may choose to give suppliers visibility into the fields you complete in order to provide selective feedback that can be used in negotiations.

Two challenges are often encountered when using detailed quoting templates. First, some suppliers will refuse to provide the visibility you have requested. The solution is to give them little choice. Make it clear that not completing the template will remove them from consideration for the business. Second, if you do not have the right tools to help enable the direct materials sourcing process, your staff may get bogged down in spreadsheet chaos. In today's global sourcing environment, eSourcing automation tools are becoming a must. Such tools eliminate the need for combining spreadsheets and building your own analysis. The hours you spend compiling data can be used for more strategic sourcing activities.

Step 4 consists of overlaying the internal costs. Here, working with other departments, especially finance, is critical. While some costs may be a simple allocation formula (e.g., compliance costs), others will be based on information you will need to collect from suppliers (lead time, capacity, currency, etc.). Get finance involved early and make sure they provide clear input on how your total costs are being impacted at the project level. Finally, take the time to build a reliable cost of poor quality model. Separate formulas will be needed for existing suppliers (where you should have existing quality data) and potential suppliers (where you will have to estimate).

Step 1:
Define total
cost and
identify
components

Step 2:
Develop a
roadmap to
collect cost
info

Step 3:
Create a
two-step
cost
template

Step 4:
Overlay
internal
costs

Step 5:
Compare,
negotiate,
decide, learn

Step 5 of the process involves comparing quotes, conducting negotiations, making the decision, and learning from the information provided. Once again, you will make better decisions, and save more money, if you can automate the comparison and analysis process and spend more time on developing a winning negotiation strategy. Using software built for direct materials sourcing can be a significant enabler here.

The negotiation process itself can provide a very enlightening view into total cost as you can gain a consistent understanding of market trends cutting across all suppliers, as well as costs that seem to be padded. After your decision, be sure to track the quoted costs of the awarded suppliers to the actual costs to assess potential gaps in the process. Also update any should cost or target cost models based on your market findings.

Summary: It is a proven fact that having greater visibility into total cost leads to better sourcing decisions and higher profit margins. Applying this framework and aligning your people, process, and technology around a total cost sourcing strategy can improve both the efficiency and effectiveness of your direct materials sourcing team.

About Directworks

Global manufacturers strive to select the right suppliers for the direct materials they use to build their products. Directworks provides manufacturers with a powerful software platform specifically built for engaging suppliers and sourcing direct materials. Our cloud-based solution empowers sourcing professionals to do their job faster and more efficiently; enabling them to focus on strategic work and contribute greater value. By automating and streamlining tactical activities, sourcing teams are free to concentrate on more important activities: collaborating effectively with suppliers, gaining a deeper understanding of cost drivers, and negotiating best total cost. The results: significant sourcing savings while maintaining quality and effectively managing risk. Our customers are leading, global product companies across the spectrum of manufacturing: aerospace and defense, automotive, consumer goods, diversified industrial, high tech, and medical devices.

To learn more, visit us at www.directworks.com.



Whirlpool Improves Direct Materials Sourcing with Help of Directworks

Whirlpool Corporation, the leading manufacturer of home appliances, has no desire to sit back, watch, and wait as the marketplace changes. Recognizing the critical role that direct materials sourcing plays in sustaining quality, maintaining production, and preserving margin, the corporation has set out to transform its Global Strategic Sourcing function. The success to date not only has strengthened its competitive advantage, but has resulted in tremendous savings.

With 68,000 employees and annual sales of more than \$19 billion, Whirlpool has been built on a culture of success through doing the right thing and living up to its commitments, whether times are good or challenging. Historically, Whirlpool has used innovation to help maintain its success during difficult economic times. As the most recent global economic downturn continued, the company took steps to ensure product quality while experiencing as little margin erosion as possible.

Based on lean principles and a philosophy of collaboration, the Global Strategic Sourcing (GSS) organization set out to create a market-leading sourcing discipline and structure. Led by John Miller, senior vice president, the mission of the group is to support the achievement of global product leadership by delivering the best value for cost (i.e., price paid while optimizing quality and minimizing risk). Two elements to help support this activity were:

- Improving the speed and efficiency of the sourcing process
- Standardizing the RFX processes and activities

The Global Strategic Sourcing transformation was driven by the need to achieve global scale through standardizing its processes and workflows across the Purchasing organization.

With its mission firmly in place, Whirlpool closely examined the barriers that stood in its way. The sourcing team was under tremendous pressure to complete projects quickly. To do its job well, the team needed the right tools, but a look at its processes clearly showed a lack of the right technology to achieve the desired transformation. The company's existing eSourcing tool was acquired for indirect sourcing and lacked required direct sourcing functionality; it could not enable the makeover of the direct materials sourcing process.

"Directworks provides us with enhanced capabilities for managing our global sourcing and cost management activities. These resources support our continuous effort to improve cost and quality of our portfolio of leading brands."

- John Miller, Senior VP Global Strategic Sourcing, Whirlpool Corporation



Reliance on spreadsheets and email as the primary quoting and analysis method yielded typical challenges, including:

- Lacked enough time for strategic analysis and discussions
- Experienced less than desired visibility into total costs
- Juggled more than one "system of record"
- Collected, then consolidated, data from numerous, disparate systems
- Struggled to deal with revisions based on spec changes made "mid-process"
- Slowed by data collection processes that were prone to error or misinterpretation

All of these challenges forced the team to make sourcing decisions under pressure, without access to complete, accurate information.

Whirlpool sought to free its sourcing professionals from manual, error-prone tasks and inadequate information, and enable the team to be strategic. Whirlpool searched for a solution that would automate and streamline both the quoting and analyses phases and create clearer total cost visibility. As a result, Whirlpool selected Directworks as the solution.

Directworks empowered Whirlpool Corporation's sourcing professionals to do their job faster and more efficiently, enabling them to be more strategic with their day-to-day activities. Directworks helped Whirlpool:

- Standardize the event and bidding process for all suppliers and Whirlpool events
- Create a global repository for quote and supplier information
- Improve the efficiency of the data gathering processes and link directly to Target Cost Management
- Align detailed quote information with cost modeling and regional cost libraries
- Improve on-line collaboration between Procurement, Engineering, and current and potential suppliers (all within the sourcing tool)
- Enable central tracking of all communications concerning a bid event
- Improve speed to market in release of sourcing events
- Provide management with easy access to results
- Allow grouping of suppliers for projects, events, communications, and bidding

Freed from the burden of mundane tasks, the sourcing team could more easily collaborate with suppliers and negotiate the best total cost, while maintaining quality and managing risk.

About Whirlpool Corporation

Whirlpool Corporation is the world's leading manufacturer of major home appliances, with annual sales of approximately \$19 billion in 2012. Whirlpool has 68,000 employees and 65 manufacturing and technology research centers around the world. The company markets Whirlpool, Maytag, KitchenAid, Jenn-Air, Amana, Brastemp, Consul, Bauknecht, and other major brand names to consumers in nearly every country around the world. Additional information about the company can be found at <http://www.whirlpoolcorp.com>.



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