



THE SHELBY GROUP

PAYING THE NEGOTIATED PRICE?

# A Baseline Pricing Model for Improving Price Visibility and Confidence

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**WHITE PAPER** | PROCUREMENT OPTIMIZATION

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# EXECUTIVE SUMMARY

Even after a successful implementation of P2P Automation software, there exists a possibility for the incorrect price of a purchased commodity to be introduced into the Source-to-Pay cycle. This is possible, primarily in cases where suppliers control pricing, such as Punch-Out Catalogs or invoices without a PO. By employing the three components of the Baseline Pricing Model (Price Baselining, Systematic Invoice Review, and Supplier Management), incorrect prices can be a thing of the past.

The Baseline Pricing Model presented below describes universal concepts that add visibility and create confidence in the prices you pay. The business intelligence created during this process gives your organization powerful leverage in relationships with your suppliers.

## Problem: Lack of Confidence in Invoice Pricing

Maybe P2P Automation has been implemented in your company for years or you just finished an End-to-End P2P Implementation. In either case, contracts are uploaded, hosted catalogs are stocked, Punch-Out Catalogs are linked, approvals are flowing, invoices are coming in, and payments are going out -- all on time, like clockwork.

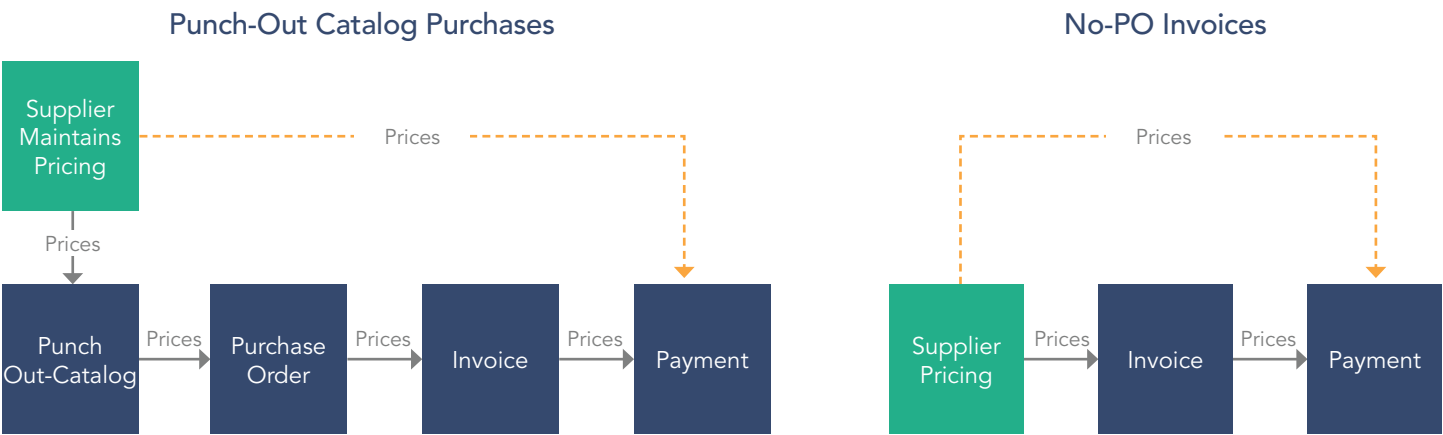
Still, you have that sinking feeling, "How do I know we are paying the negotiated prices?"

With a Hosted Catalog, your organization manages pricing and you have the ability to implement

contract terms. In other scenarios, your pricing is entrusted to your suppliers and their prices flow directly into your payment.

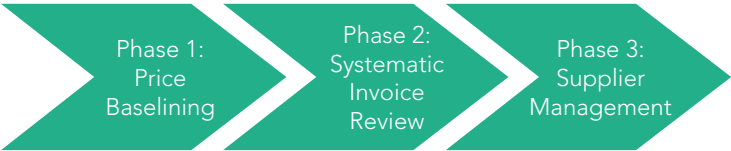
Maybe you have problems with your suppliers, or maybe you just went through a long negotiation to win concessions. Even with the best supplier partnerships, and the best of intentions, failures are possible and your organization pays the price. In any case, knowing that you are paying the negotiated price is mission-critical to a world-class procurement organization.

What is the negotiated price? How do you know you are paying it?



# Solution: Baseline Pricing Model

## Overview



The Baseline Pricing Model is a methodology for establishing the correct prices for products that you buy, in which you ensure that suppliers are invoicing appropriately at those prices. This is achieved with three major components:

- **Price Baseline** – Determining the correct price across products/categories/suppliers/etc.
- **Systematic Invoice Review** – An iterative process of sampling and validating bills against the Baseline Price.
- **Supplier Management** – Working with suppliers to correct failures and ensure compliance.

According to research performed by the Aberdeen Group in 2012, the most common problem with Supplier Management is a lack of insight into supplier performance against negotiated terms. The goal of the Baseline Pricing Model is to create visibility and confidence in supplier pricing, and add leverage to relationships with suppliers while minimizing the resources required to do so. This is possible by taking a structured approach to determining the correct price, reviewing invoices, and resolving discrepancies. Through disciplined use of the Baseline Pricing Model, organizations of all sizes and complexities can gain confidence in supplier pricing.

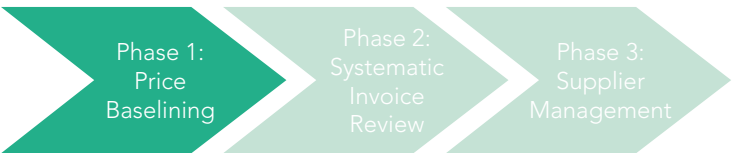
## Scalability

The Baseline Pricing Model is designed to scale to the needs of individual organizations. For smaller organizations, Baseline Pricing may reside in spreadsheets maintained by a single administrator and Invoice Review requires just a few hours a month. For large organizations with a dedicated Spend Analytics team, Baseline Pricing may require a custom database and dedicated resources for Invoice Review and Supplier Management. While the concepts stay the same, implementation of the model may vary widely. The concepts presented in the Baseline Pricing Model apply to all organizations, regardless of complexity, spend levels, industries, pricing structures, etc.

## Roles and Teams Involved

### Phase 1: Price Baseline

Phase	Team Assigned	Responsibility
Price Baseline	Price Baseline Team	Create initial Baseline and handle updates as needed
Systematic Invoice Review	Spend Analytics Team	Determine Selection Criteria, perform Invoice Reviews, distribute summarized results
Supplier Management	Sourcing Team	Manage suppliers based on results of Invoice Review



Like other forms of Baseline, the goal of Price Baseline is to determine what the correct price is based on contracts, other agreements, or expected trends.

Prices are structured in a variety of ways:

- Contract-defined price lists
- Contract-defined discounts on regularly published price lists
- Volume-dependent pricing
- Market-defined pricing
- And many others...

### Contract-Defined Price Lists

These are negotiated prices, specific to each relationship and are un-ambiguous. Maintaining the Baseline Pricing is as simple as drawing the price list from the contract and updating the Baseline whenever contracts change.

### Regularly Published Price Lists (with or without discounts or pricing modifiers)

Under some arrangements, supplier pricing can change without a new contract. If the supplier

publishes updated price lists, these should be incorporated into the Baseline Prices as soon as possible. Including these prices requires regular updates from suppliers that are modified with any contractual discounts, etc.

### Volume-Dependent Pricing

Volume discounts are common and require that the Baseline Price considers volume while evaluating correct pricing. Any change to contracts or changes in volume can affect the Baseline Price for a given invoice.

### Market-Defined Pricing

Market pricing requires market-aware Baseline Pricing and includes the risk of frequent/irregular updates. Any invoice for market-priced products requires additional attention and a unique Price Baselining methodology. Depending on the scale of your organization, this can include tolerances based on forecasted pricing and other analytical approaches that keep spend in check.

### Other

Price Baselining is a robust and flexible approach designed to adjust to the terms of each contract and supplier. You may not even have a contract, as the agreement may have been made over email or in a meeting. In some cases, exact pricing cannot be known up-front and tolerances are used instead.

**Note:** Frequent changes to pricing without notice may result in false-positives during Invoice Review. Supplier Management should be used to mitigate this as much as possible.

During the Invoice Review phase, you will see that there are techniques for confirming prices, even when a price list is not provided or no formal contract exists.

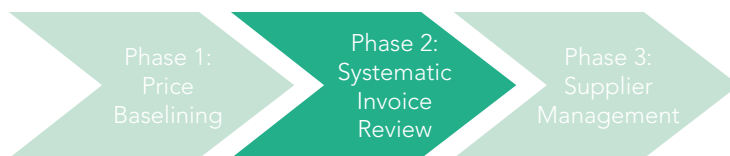
### Advantages of Price Baselining

There are many advantages to creating a Pricing Baseline:

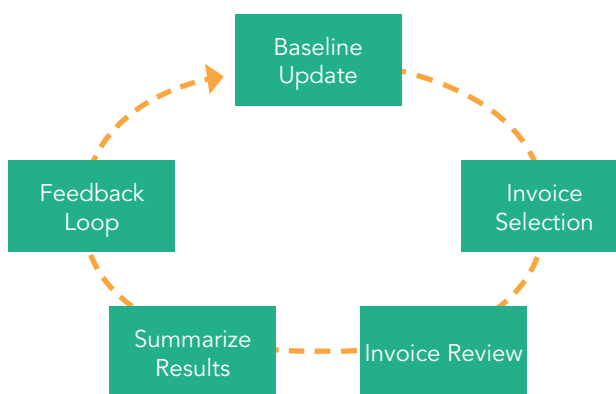
- **Standardized Format** – Contracts come in all shapes and sizes. Creating a Baseline Pricing Model puts mission critical data into a single format to simplify Invoice Review.

- **Central Repository** – Having a single source of the truth for pricing makes it easy to answer the question: Did we pay the price we negotiated?
- **Efficient Invoice Review** – During Invoice Review you can focus on the invoices at hand, not re-interpreting contracts every cycle.

## Phase 2: Systematic Invoice Review



Systematic Invoice Review is a regular process where invoices are selected into Invoice Pools, Invoice Pricing is compared to the Baseline Price, and results are summarized.



### Baseline Update

Updating the Baseline Pricing Model is an ongoing process. By doing so, you ensure your ability to confirm pricing for a given invoice and to quickly take corrective action. It may require some time to complete the update, but the payoff of an accurate Baseline Price you can trust is well worth the effort. Regular updates keep the time spent each month to a minimum.

### Invoice Selection

According to a study published by Aberdeen Group in August 2012, *Supplier Lifecycle Management – Measuring Performance while Mitigating Risk*, the number one reason AP needs improvement is a lack of visibility into invoices and AP documents. Invoice Selection is the main lever used to move visibility to invoices that need it most.

The goal of Invoice Selection is to identify a representative sample of invoices that can tell you if your entire process is in line. The key to good Invoice Selection is pre-defining Invoice Pools for review. An Invoice Pool is a random sample of invoices with pre-defined criteria that represent a larger group where visibility is needed.

For example, an Invoice Pool may be defined as follows:

- Supplier XYZ
- Office supplies
- Spend between \$100 and \$1,000 per invoice
- 20 invoices
- Reviewed every month

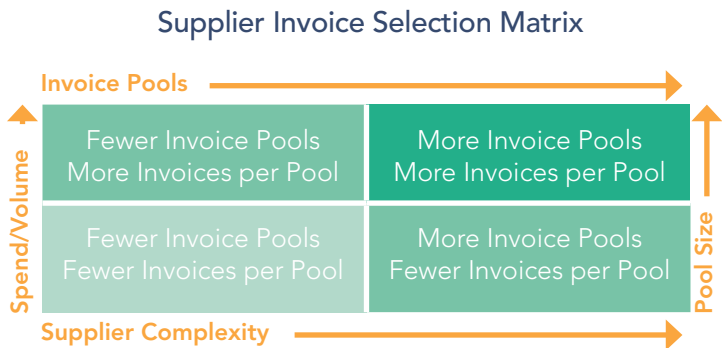
Invoice Selection is the process of using the pre-defined Invoice Pools to randomly select invoices for review. Invoice Pools will often share similar Baseline Pricing structures, making the selection and review of an Invoice Pool a single unit of work assignable to a resource. For larger organizations, Invoice Pools are category or sub-category specific. Smaller organizations may create Invoice Pools solely around suppliers.

By carefully selecting a small representative sample for each pool, you can gain insight into hundreds or thousands of invoices. There may be many areas where visibility is critical, such as in items you've never purchased before, suppliers you've never used before, large suppliers with broad ranging catalogs, or invoices that don't have a purchase order. By creating a set of rules, you can gain visibility on all these areas without combing through every single invoice.

How many, and how often, you review invoices depends on a few factors:

- **Volume** – You don't need to review every invoice for large suppliers to know if there is a problem. Similarly, small suppliers can be effectively reviewed less often with the same results.
- **Spend** – Higher spend means higher risk, while lower spend often means less attention to detail. Selecting a variety is the key to covering your bases.

- **Supplier Complexity** – A single supplier may cover multiple categories, engage several divisions in your company, and have varying contractual structures. Creating Invoice Pools simplifies this complexity.
- **Problem Areas** – The Baseline Pricing Model identifies common problem areas. Defining Invoice Pools puts focus on these areas until they are resolved.



The Supplier Invoice Selection Matrix illustrates how Invoice Pools are defined:

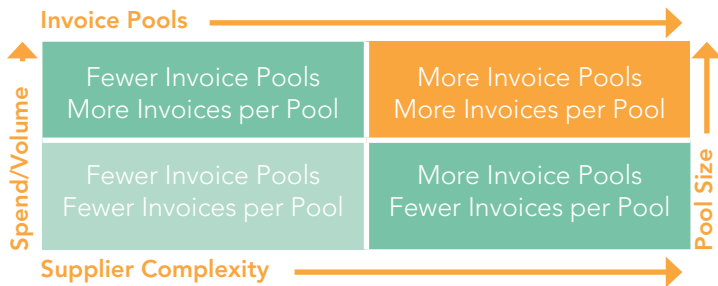
- As Spend and Volume for a supplier increase, the size of individual pools are increased to ensure that representative sample is taken.
- As Supplier Complexity increases (multiple categories, multiple spend-levels, etc.), new pools are created to handle the added complexity.

Defining Invoice Pools is about finding the right balance that lets you do “a lot with a little.” The guidelines in this section help your organization create custom Invoice Pools that make sense for your business.

When it comes to Invoice Selection Criteria, it's all about your business. There are no magic numbers and the final step of review – “Feedback Loop” – is where Invoice Pools are adjusted to meet the needs of your business.

In short, use the numbers and definition as a starting point, not the final word.

## Supplier Invoice Selection Matrix



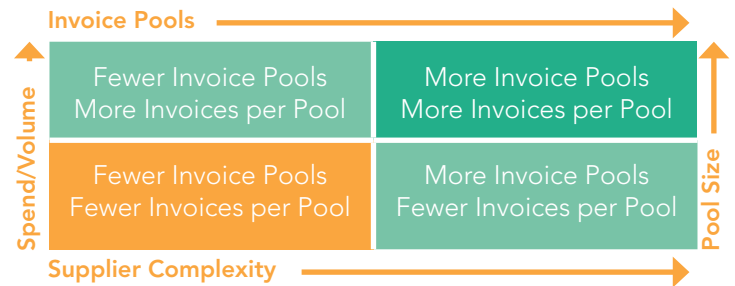
### High Spend, High Complexity

These are typically strategic suppliers, covering multiple categories or divisions. These should be reviewed every month. As complexity and volume increases, the opportunity for failure also increases. An exception found in just a couple of invoices could indicate a supplier-wide problem, while a successful review of the right sample gives you the confidence that these key suppliers are on point.

#### Selection Criteria:

- **20 High-Spend Invoices** – The risk of a failure on a single high-value invoice can be a risk to your organization and a sign that there is trouble in the water.
- **20 Medium-Spend Invoices** – The “middle child” of invoices; these may not fall into “high-spend” or “low-spend” categories, but they can have their own unique challenges. Reviewing a broad spectrum of invoices is important for ensuring all invoices are flowing properly.
- **20 Low-Spend Invoices** – Small invoices often add up to a significant share of spend at larger suppliers, and due to their size, they are often over-looked. It is important to maintain the discipline to review a sample of even the most mundane invoices.
- **20 First-Time-Buy Invoices** – New products often have their own unique characteristics; reviewing them after their first purchase is a chance to catch setup issues, etc.
- **All Invoices from Problem Areas** – This is where Invoice Selection is a powerful tool for efficiently maintaining focus on problem areas. This criteria allows you to keep these invoices in the penalty box until you are confident that a problem has been resolved.

## Supplier Invoice Selection Matrix



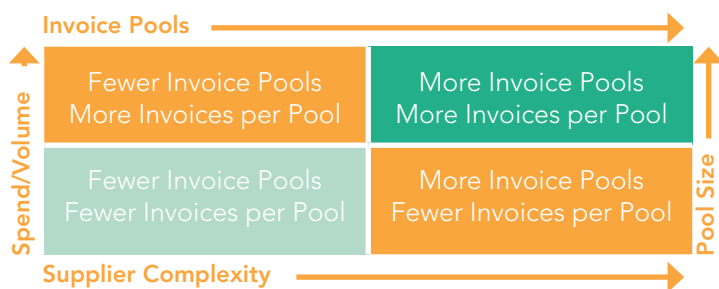
### Low Volume, Low Complexity

These may be small local suppliers that are not strategic, but regularly supply products. For smaller suppliers, a monthly review can be overkill. Instead, create a rotating schedule where small suppliers are reviewed quarterly, or even just twice a year depending on invoice volume. This also reduces resource needs for Invoice Review.

#### Selection Criteria:

- **5 High-Spend Invoices** – Even small suppliers can have higher spend invoices from time to time. These are important to review because the supplier may be less experienced with high-value invoices.
- **5 Low-Spend Invoices** – These should be the bread and butter of small suppliers, which means they are a great indicator of whether the suppliers may have system or process issues that impact invoicing.
- **All Invoices from Problem Areas** – Again, this is how you stay on top of invoice problems until they are fixed.

## Supplier Invoice Selection Matrix



### Other Suppliers

High Spend, Low Complexity and Low Spend, and High Complexity Suppliers are less common but they do exist. Use the Supplier Invoice Selection Matrix as a guideline for determining when to have more or less Invoice Pools and how many invoices to include per pool.

### Problem Suppliers

Inevitably, your network may have one or two suppliers that always seem to have a problem. This is where the Baseline and Invoice Review help you pinpoint the exceptions to have them corrected. Sometimes those exceptions may include an entire supplier. Using the Baseline Pricing Model will minimize the resources these suppliers drain from your organization.

Selection Criteria:

- **All Invoices Reviewed** – If you don't have confidence in a supplier, a careful review of all invoices is recommended. It's better to spend some time upfront than to chase down a refund from someone you don't trust.

In the case of problem suppliers, you may choose to review all invoices against the baseline *before* payment.

### Invoice Review

Once your Baseline is up-to-date and you have your selection of invoices to review, the Invoice Review process is straight-forward:

1. Invoice Lines are matched against the Baseline Price
2. Invoiced Prices are compared to the Baseline Price

3. Exceptions are reviewed and confirmed by the Procurement Analyst

Matching invoices to the Baseline Price can take many forms, depending on how pricing is structured:

- **Price Lists** – If a price list is drawn from a contract or is published by a supplier, this can be as simple as matching Item Identifiers to lookup the Baseline Price.
- **Volume Pricing** – Very often, discounts depend on volume. In these cases, the additional step of matching price breaks is required.
- **Market Pricing** – Depending on the product (food items, other commodities, etc.), your Baseline may be updated more frequently. A direct comparison of invoices against the source for market data may be required, especially for first-time purchases. Take the time to update the Baseline Price where possible.

### No Contract or Prices Unknown

Sometimes agreements are made over email or on a handshake. In such cases, the Invoice Review team uses the following techniques to confirm pricing:

- **Interviews** – Working with the buying department can often reveal the original source of an informal agreement, where pricing can be obtained and updated as the correct Baseline Price.
- **Contacting Suppliers** – When the original source of the agreement is not available (or no longer with the company), a supplier should provide you with emails or price lists that were used at the time of the original agreement.
- **Historical Analysis and Trending** – In the case of variable or unknown pricing, the best data source is already in your procurement system:
  - o Compare against past invoices - "We have always paid \$15 per red stapler."
  - o Trend pricing over time to see if changes are in line – "Food prices have increased 5% each of the last 4 years. These slightly higher prices are in line."

Whatever methodology is used, you must empower your procurement organization to seek out correct pricing

wherever it lies. While the perfect case is a contract-defined price list, *perfect* doesn't always happen. Do not regard it as losing control of your pricing. An organization trained in Price Baselineing will seek out correct pricing.

Summarize Results

Next comes the all-important step of analyzing the data collected during Invoice Review into useful business intelligence. This is done by applying context from your business to create a powerful tool for senior leadership to make decisions. Did you recently bring a new supplier on board? Maybe you need extra insight into whether your ERP Implementation is impacting invoicing. In any case, this step is the key to Supplier Compliance.

This simple, yet powerful, summary draws a clear path for your procurement organization to take action immediately in order to resolve any issues. It also delivers the appropriate message to key stakeholders, giving leadership the confidence that suppliers are charging the correct prices.

Feedback Loop

The true power of the Systematic Invoice Review process is the feedback loop effect; each subsequent review is increasingly tuned to your business, your suppliers, and your process. Now is the time to review and adjust the process based on what worked and what didn't.

Invoice Pools

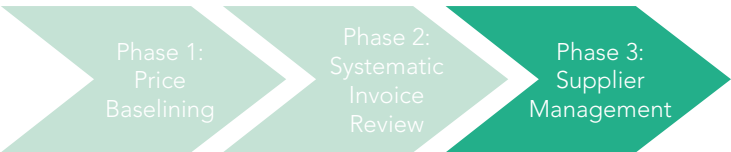
Invoice Pools set the direction and priority of the Systematic Invoice Review. Take time at the end of each cycle to review the existing criteria and make the needed adjustments:

- **Increase Pool Size** – For recurring problem areas or problem suppliers, increase the number of invoices included in the Invoice Pool. In some cases, a review of all invoices may be required.
- **New Pools** – You may find patterns of failure that prompt new samples. For example, if drop shipments frequently use the wrong shipping charges, create an Invoice Pool around drop-shipped invoices. This ensures that the area gets attention during the next cycle.
- **Retire Pools** – Review Invoice Pools that were previously added for problems areas. If the problem has not recurred, remove the Invoice Pool from Invoice Selection during the next cycle.
- **Reduce Pool Size** – If a supplier has reliable performance, decrease the number of invoices in their Invoice Pool(s) to save time during review and focus on more critical pools.

Baseline Pricing

If new Invoice Pools are created, you may need to revise or expand the Baseline Pricing Model, or adjust tolerances to accommodate this new scrutiny. This step may take place after revising your Invoice Selection Criteria, or any time before the next cycle's Invoice Review process.

Phase 3: Supplier Management



Supplier Management is critical at two points in the Baseline Pricing Model: During Launch and after Invoice Review.

Supplier Pricing Compliance

Supplier	Total Invoices	Total Spend	Invoices Reviewed	Spend Reviewed	% Spend Reviewed	Notes	Action Plan
Company A	300	\$90,000	60	\$18,000	20%	3 invoices missing free shipping	Contact supplier for account credit
Company B	250	\$62,500	20	\$5,000	10%	Fully Compliant	None
Company C	100	\$5,000	50	\$3,000	60%	Discount not in Punch-Out Catalog	Hold all payments Contact supplier immediately

## During Launch

When your organization launches a Baseline Pricing Model, it is important to educate your suppliers on the process. You won't share every detail, such as Invoice Selection Criteria, but communicating your expectations before presenting summarized results makes it clear to suppliers on what to expect.

Communicating with suppliers during launch has other benefits:

- **Answer Price Baselining Questions** – Use this time to determine when and how Price Lists are published, how market-driven pricing is calculated, confirm that Punch-Out pricing reflects contractual terms, or any other inquiries you may need answered in order to create a Pricing Baseline.
- **Establish Contacts for Pricing Concerns** – Identify the supplier contact(s) that will receive the Summarized Results and will address any concerns/failures discovered through the Invoice Review.

In many cases, informing a supplier that they are being measured will cause a change in behavior even before beginning the Invoice Review. Note that the same launch process applies to new suppliers introduced to an existing Baseline Pricing Model.

## After Invoice Review

The results of your Invoice Review show whether or not suppliers are meeting expectations. Having the discipline to conduct Invoice Reviews regularly and communicate the results shows suppliers that you are serious about pricing compliance.

Corrective actions may include:

- Holding payments to problem suppliers
- Requiring suppliers to correct Punch-Out Catalogs
- Negotiating account credits/refunds
- Establishing a broader Invoice Review
- Changing future negotiations

## Price Changes without Notice

In some cases, suppliers may change prices without notice. This practice is a risk for the Baseline Pricing Model as there is no way to validate Invoice Pricing without knowing what the correct pricing should be. Work with suppliers as much as possible to get notification of price changes and consider making price change notifications a condition of future negotiations.

While specific actions vary from case to case, the message should remain constant, in that every invoice must be correct.

## Summary

A well-run P2P Automation Suite is an important step in Supplier Management, but it's not the end of the story. There's still opportunity for process failure and human error, and the Baseline Pricing Model constitutes a powerful set of tools for identifying pricing problems and correcting supplier behavior.

Establishing a Pricing Baseline requires understanding contracts, working with suppliers, and some analysis, but the returns are well worth the effort. Knowing what the negotiated price is, is key to knowing if you're paying the correct price.

Performing regular Invoice Reviews creates an expectation of excellence with suppliers and builds a wealth of business intelligence to frame future negotiations and sourcing decisions. Establishing a process of on-going improvement is possible with the right discipline and a carefully constructed Pricing Baseline.

Supplier Management is the all-important step of turning business intelligence into action. By consistently sending the same message, and backing it up with data, your suppliers will know you are serious about Invoice Pricing.

The Baseline Pricing Model is a flexible, robust set of concepts which will empower your organization to effectively correct Invoice Pricing issues, while bringing confidence to Invoice Pricing.

**For more information about our Procurement Optimization services, call us at 312.445.8500 or email us at [info@theshelbygroup.com](mailto:info@theshelbygroup.com)**