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INTRA GROUP TRADING

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How many buyers find that their worst supplier is a sister company? **Andy Williams** looks at trading between sister companies.

When we discuss relationships with suppliers, it is almost invariably in the context of a model which assumes that they are part of a separate commercial entity from ourselves and answerable to a different set of managers and shareholders. This in turn suggests a model for negotiation in which each party has interests distinct from the other; their representatives, typically the salesman and the buyer, then have the task of finding where and how these interests can be made to overlap. However, for buyers in large organisations, a significant proportion of spend is frequently with other companies within their own group (what I have called intra group trading). Furthermore this spend is often on products of a strategic nature. The reasons for this are straightforward but worth looking at because in part they underlie some of the problems that buyers encounter.

Intra group trading

Unless the group in question is a true (and currently unfashionable) conglomerate, the products of its subsidiaries are by definition related either in terms of technology or of the market. Often the drive to create the group has come from a conscious desire for vertical integration. Even where this was not the case supply chains will tend to form and be reinforced by other considerations such as capacity utilisation and corporate image.

In any group of companies it is improbable that capacity will be fully utilised in all the subsidiaries all of the time; an ideal balance is almost impossible to achieve and probably occurs momentarily if at all. Generally speaking, imbalances arise because of fluctuation in the market. However, groups sometimes maintain idle capacity as an act of deliberate policy because the activity concerned is regarded as strategically important or on occasions, because it is one with which the senior managers of the group have previously been associated. Whatever the reason, the outcome is frequently the same: surplus capacity costs money, a programme to minimise its effects is set in motion, and the sister companies come to be looked on as captive customers.

Allied to this is a natural fear that business which does not remain within the group will help to strengthen a rival.

An additional incentive to intra group trading lies in considerations of corporate image. This takes two forms. First there is the case of an activity whose relevance and profitability may have become dubious but which is somehow identified with the history and image of the business. Thus groups end up clinging to an irrelevant niche in the consumer market because it includes the product they started with, or they maintain an outdated facility because it was the original factory. A second expression of this drive is the desire to stamp final products as fully as possible with the corporation's badge so that it marks not only the system but as many components as possible within it. It would be interesting to see an objective study of how seriously end customers take this process.

Strategic purchasing

In future we are likely to see these pressures toward intra group trading reinforced. The purchasing world is moving increasingly to adopt long term relationships with suppliers. This requires detailed understanding of the supply chain and a mutual commitment to improvement in all areas affecting cost and quality, expressed through negotiation and the formation of binding agreements. On the one hand these are not characteristics of intra group deals; on the other, as long term deals become the norm, the commercial significance of the switching business to third party supplies becomes greater.

Reality

It is important to emphasise at this stage that pressures to keep business within a group are not somehow wrong headed. They are not just an intrusion into the buyer's right to decide but represent real commercial imperatives which he must live with. It is also worth stating that I know of no group which suffers all the problems I am about to describe, nor any group which is entirely free of them.

How many buyers find that their worst supplier is a sister company? That such companies are reluctant to make commitments and even more reluctant to fulfil them? I believe it to be a majority of buyers in groups and, I suspect, a large majority at that. This is no matter of chance. The way in which intra group trading is conducted does not encourage good performance for logical reasons.

Agreements

I recall on one occasion being told by the commercial manager of a sister company that he was happy to sign a contract whose terms he disagreed with. "After all", he said, "you're not going to sue us". Behind this apparently simple statement of fact lay the knowledge on both parts that making any agreement stick was not going to be easy, and so it proved.

While trading between unrelated companies has as its ultimate basis recourse to law in the event of severe disagreement, sister companies can scarcely afford to be seen parading their differences through the courts and no group would tolerate it. In practice, agreements tend to be arbitrated by the MDs of the companies concerned or by central management. This is unsatisfactory for several reasons. First, it is unlikely that they will have full knowledge of the background to the problem. Second, it becomes bound up with other intercompany issues and the managers concerned are very likely colleagues or rivals in group machinations for which the deal in question has little or no relevance, and their judgment will be coloured accordingly.

Last, there is the wimp factor. A buyer or seller who feels compelled to appeal for justice to higher management risks being seen not merely as a nuisance, but as unable to handle his own problems.

Here, then, is one of our underlying problems. Intra group deals are perceived as lacking legitimacy. In groups with a strong hierarchical tradition, particularly those where people frequently move between companies, the question of seniority also intrudes. In dealing with third parties we tend not to worry about it unduly, and senior buyers deal with MDs, sales reps, procurement directors and so on. However where sister companies are concerned, the distinctions of grade and status become both finer and more significant. The buyer dealing with a slightly more senior salesman from his own group may me inhibited not only by rank but also by the knowledge that they may one day be working for the same company.

The necessity to negotiate is often circumvented by reference to "inter company terms". These are implicitly assumed to cover the necessary contractual detail, but it would be a safe bet that most buyers who so refer have never seen the terms in question. For many groups they exist only with reference to clearing invoices and even if they are more comprehensive, they are necessarily of such a general nature that they cannot reflect the particular objectives of specific purchasing decisions.

Occasionally the process is carried a step further with the active imposition by central management of constraints on negotiation. This may take the form of standard trading terms and/or centrally determined transfer prices (which I shall examine later in this article) and is sometimes said to have the benefit of freeing management resource for other tasks. I'm not too happy with this idea. It begs a number of questions (what are managers for if not to negotiate?) and implies a zero or even negative sum model. In other words negotiation is assumed to produce losers at least as much as it produces winners and thus unable to contribute to the group as a whole. If the process is carried on in an atmosphere of confrontation, there is justice in this view, but at the same time a more positive approach (what Karrass would call the "problem solving mode" of negotiation) is also excluded.So we can already see that the buyer/supplier model that we use in talking about purchasing does not operate in the same manner inside a group.

Supplier performance

A further divergence occurs when we look at the question of supplier performance and improvement.

Intra group buyers start at a disadvantage in that their supplier often gives priority to his external customers. They are seen as harder to win and probably harder to please. The result tends to be poor performance on internal contracts and is almost certainly the biggest single cause of problems in intra group trading. It does not help that this view is based on a fallacy for no matter how long the internal supply chain may be, at the end of it is an external customer. Not only that, but the longer the supply chain, the greater the added value which the group has generated. With this perspective it is reasonable to argue that internal customers should receive the highest priority. Nevertheless in the real world problems of performance persist within groups. Moreover, the methods we use in improving third party supplier performance are constrained in much the same way as is negotiation. Whereas a buyer may feel no difficulty in upbraiding an external senior manager for poor performance and then (hopefully) sitting down with him to work out an improvement plan, it is not so easy when the manager concerned is a member of your own group. It is traditional for subsidiaries to report their performance monitors up to the centre and agree improvements with them. The internal customer has not generally been regarded as having a role to play in this activity.

Intra group pricing

Pricing policies within groups are often complex to the point of seeming incomprehensible to the average buyer. It is rare for prices to be left to the free play of negotiation between the parties involved and other considerations intrude such as:

- Making it easier to forecast output values
- Simplifying the running of standard costing
- Making foreign currency exposure as predictable as possible, sometimes with the aim of netting it out over the whole group

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- In international transactions, making sure that profits are generated where they incur least tax liability
- Protecting strategic or key activities of the kind already discussed

This final ambition is sometimes expressed as a form of competition policy which says "you will place business in-group provided that the price is not more than x per cent above the market" On the other occasions the conditional clause is omitted.

The risks of this approach are pretty clear. Besides alienating managers at local level from decisions which are key to their businesses, it opens the way for prices to be or become out of line with the market. This distortion of pricing is passed along the supply chain affecting the competitive position of each company in turn (this applies equally to rate instances where prices are artificially low). It can be further exaggerated if, for example, overheads or risk are allocated on material costs. In a situation where one or more businesses within the group are being protected, the tendency to dole out their surplus costs around the group disguises the real cost of maintaining the resource, thus contributing to delays in deciding what to do with them.

At the same time, most groups now operate a policy where the individual subsidiary is treated as a profit centre and is expected to produce financial results which genuinely reflect the quality of its performance. Within the company the purchasing department is almost certainly being measured; where performance is assessed against standard costs and these include the premium paid to sister companies, there may be no apparent effect. However, we are increasingly and rightly being expected to perform against other criteria. These include the consistency and quality of deliveries and, as I've suggested, these are likely to be out of step with the market because intra group customers get lower priority. To sum up, we have a situation where the nature of large groups makes internal trading at least desirable, if not necessary; where that same structure creates conditions where the benefits of freely negotiated agreements in a free market are lost; and yet where the component parts of the group, whether companies or individuals, are frequently measured as though operating in a free market. Is there any way out of this?

Benefits

Let's begin by stating a number of assumptions:

- If purchasing managers could handle the problems alone they would not arise in the first place
- The best most far reaching improvements are customer driven
- That negotiation can be positive-sum (or win win, if you prefer).

Each probably merits an article in its own right but to be brief, the first is self explanatory. The people who are generally most aware of problems are in the purchasing function not only because they have to live with the daily problems that go with intra group trading, but because they know how good the suppliers perform by comparison. There is no reason to suppose that they would not extract an average performance at the minimum out of sister companies if there were not the sort of obstacles I have been describing.

As to the second, I'm not alone in believing that good companies get that way by taking on board the goals of their customer, and all their customers at that. This is not commercial surrender so much as marketing taken to its logical conclusion. (See Peters and Waterman In Search of Excellence for a description of the effect of this culture has on companies). However, if companies cut themselves off from this influence in whole or part because their customers are part of the same group, they are losing the biggest possible drive to improvement.

A logical extension to this argument and supporting my third assumption is the belief that relations between customer and supplier naturally tend to operate to the benefit of both (or else why bother doing business at all?).

Negotiation can either swing the benefits in favour of one partner, which is the zero sum model. I prefer this description to the win-win model as the latter is identified by some commentators as meaning simply that you should try to make your opponent feel good when you nail him. This may be fun but it is not, I would suggest, the way forward for intra group trading.

From these assumptions we can derive sets of actions, the first of these sets consisting of the things buyers can do for themselves.

Status quo

Buyers in large groups have to be more prepared to challenge old-established assumptions, not only for their own sake but ultimately for that of the group. "Inter company terms" should not be accepted as covering all situations. Buyers should insist on the right to negotiate specific agreements; moreover, they should tailor those agreements so as to focus attention on areas where previous performance has been poor. This approach will often succeed simply because it catches people by surprise, or else because they do not believe it will ever be made effective like the commercial manager I described earlier. In his case, I failed in that I did not achieve the performance on the contract I had been looking for. However, I did make a liquidated damages claim stick amidst much political flak and that in turn provided a stimulus to subsequent improvements. Making the agreement can be the easy part; getting it to stick is seldom easy and it may be necessary to go through the cycle several times before the message begins to register. That message, however, is undeniable: the better the performance of an internal supplier, the better the performance of the group as a whole.

Monitors

The ways in which suppliers are measured can be of great assistance in this process. Existing systems should be examined to see if they really highlight problem areas, and if not, alternatives developed. For example, standard costing can disguise a poor underlying price performance. In this case, year on year price performance measures may be a valuable addition. These can be compared with the open market, either by obtaining quotations on a regular basis (which can be difficult because third party suppliers are often reluctant to quote seriously against in-house sources) or by comparison with published indices. The problems may lie elsewhere, say in enquiry response times, and these too can be measured.

Clearly the choice of performance monitor is conditional on the effort it absorbs, the importance of the related spend and the severity of the associated problems. Furthermore, objective comparison requires that all key suppliers be measured on the same basis. They must understand the nature of the measurement, and they must receive the results regularly. Given these requirements, however, performance monitors can be a powerful tool in highlighting the problems of intra group trading.

There is a potential trap here. If deficiencies exists with internal sources, then they should be exposed, but the objective should not be to move internal purchasing from a purely administrative activity to one which manages zones of conflict with sister companies. We have to look beyond that to the emphasis on long term single sourcing with the goals of total quality and continuous improvement. This is where the group as a whole has to be encouraged to think hard about its internal supply chains.

Group strategies

For the management of large groups, there is a choice of options about how internal supply is managed.

i) By traditional means. The supply chain exists because policy says that it will. Prices are fixed; the internal customer has an administrative role; response to external customers is the problem of the company at the end of the chain.
ii) By means of the profit centre. Measure each company on its individual profitability; assume a utilitarian model of the greatest overall good arriving by means of the aggressive pursuit of individual goals; the external customer remains the problem of the last company in the chain.
iii) By means of the supply chain. The interests of the external customer become paramount throughout all companies. Performance is measured in terms of service to him.

As I've suggested, few groups move beyond option (i). The commercial logic of maintaining internal supply, combined with political and interpersonal factory, mitigates against a move to option (ii). At the same time, some measure of company performance is required, so the profit centre concept comes into being. This assumes a degree of independence which, in reality, does not and probably should not exist.

What is needed is a strategy to move option (iii). This requires some fundamental changes in management thinking, for the profit centre is no longer the individual company or the group as a whole by the supply chain culminating in a final product. To reach this stage requires new policies described as follows.

Promoting the customer

Very few large groups concentrate sufficiently on spreading awareness of the end customer throughout the supply chain. This is one of the reasons why priorities are not always set in a rational manner. To change this pattern may involve at least publicity and presentations which encourage customer awareness. An active approach might involve using the customer himself to assist the process by treating the whole supply chain as his vendor and not just the last link. He may then visit or even audit companies throughout the chain. If encouraging this idea sounds foolhardy it is no more than educated customers are doing already. An incidental advantage is that at the same time as internal suppliers are being presented with a broader perspective, the customer too will tend to identify more strongly with the group.

Management teams

A logical development from thinking of the profit centre as the supply chain is to identify the managers responsible for it throughout the group and to seek to influence them to operate its overall advantage. Where possible these groups should be brought together for training with the aim of fostering a change of style (in many such cases, the supply chain concept itself will come as a novelty). This cuts across the training policies of most groups in that it requires a cross-company and cross-functional approach. It further requires a very careful choice of the agency carrying out the training.

Having identified management teams and encouraged them to a new approach, very little will be gained if they then return to companies using the old performance measures and maintaining the old perspectives.

Fostering improvement

I've mentioned the situation where groups mandate internal supply on the grounds that it is only somewhat uncompetitive. How much more powerful would this mandate be if it were expressed as "irrespective of how competitive your internal source may be now, you must use them so long as price/lead time/batch size/reject rate continues to fall by x per cent year on year? This embodies the logic of keeping business within the group and makes it harder for external sources to break in, while avoiding complacency and giving the internal customer a powerful role. The approach concentrates on the scope of improvement over the medium and long term rather than taking decisions on the basis of present strengths.

Legitimating agreements

Much of what I've said implies that the internal customer has to acquire greater significance than is often the case now. Further, he has to be able to arrive at agreements which have meaning. This is true whether the group has a free market culture or is driving towards a supply chain market.

We've already seen why internal agreements founder on the problem of legitimacy. There is much that the group can do to change this, mainly by trying to change attitudes but also by establishing ground rules. The first part of these rules is that which determines the boundaries of negotiation (such as the mandate described above). The second part should prescribe what happens in the case of disagreement or failure to comply. The best solution is reference to a strong but impartial arbitrator with the power, not merely to suggest resolutions but also to ensure that they are followed. I've already indicated that this is not a role which senior managers should be expected to perform. It may be that an external body such as a professional institute or a consultant is adopted because they appear impartial. Alternatively this may be a new role for central purchasing departments who may be expected to have a better grasp of group objectives. In either case the idea of nominating an arbitrator is not to keep him busy but quite the reverse; it is to confer legitimacy on agreements and therefore make it more likely that they will be kept.

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Articles on Japanese industry frequently cite close, long term relationships with suppliers as part of its success and as the underlying reason why vertical integration is not as strongly established as in the West. I'm not totally convinced of the latter point but it is clear that we have a long tradition of vertical integration in the West and some management habits which prevent us from taking full advantage of it. The frustration of buyers at the performance of sister companies is the everyday symptoms of these habits.

The problems are not insoluble; however, the answers do not lie solely with individual buyers in the group, nor do they lie in the aggressive pursuit of individual goals. Rather they lie in recognising the customer, both internal and external, as the driving force behind improvement and in actively encouraging him to fulfil his role.