

# Pareto Analysis in Procurement: How To Use Spend Analysis To Cut Costs



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The Pareto Principle, sometimes called the 80/20 rule, is an idea formulated by economist Vilfredo Pareto in 1896.

This principle essentially states that roughly 80% of outcomes are determined by 20% of causes for many events. It has been applied to various topics such as economics, business management, quality control, and mathematics.

In each situation, it is used to indicate that the majority of effects can be attributed largely to a small minority of causes or contributors.

As it often proves reliable when estimating outcomes, this concept is widely used by various industries attempting to maximize their efficiency.

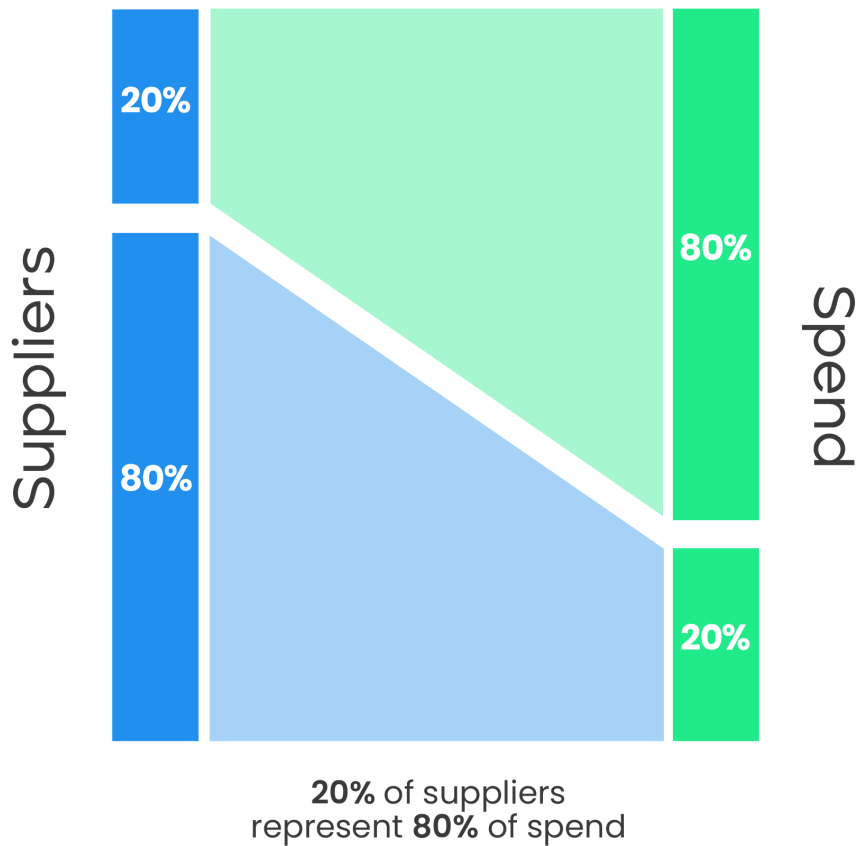
The same principle applies to spend analysis and procurement management: by focusing on the most expensive products and services, you can get the biggest return on investment in terms of cost savings. Let's take a closer look at how this works.

## **Pareto Principle vs. Pareto Analysis**

The Pareto analysis and Pareto principle are often confused and even used interchangeably, but they are two distinct concepts.

The Pareto principle, also known as the 80/20 Rule, is a heuristic that suggests that 80% of results can be attributed to 20% of causes.

## ■ Pareto Principle in Procurement



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Pareto analysis is a form of data evaluation that looks at how much of an effect individual factors have on a larger system.

This technique prioritizes which factors to address based on how much they affect the entire output or goal, making it easier to target the highest impact areas for improvement.

In short, the Pareto principle expresses the importance of prioritization when making improvements, while Pareto analysis exemplifies this approach through structured evaluation.

*Procurement professionals can use pareto analysis to examine various aspects of business and adjust strategy.*

# What is Pareto Analysis?

Pareto Analysis, also known as ABC analysis, is a data-driven approach for determining which factors are having the greatest impact on a particular outcome.

This concept can be used to identify which products or services are driving the highest costs within an organization's procurement process.

By analyzing spend data, companies can identify the specific items where it makes sense to focus their efforts for cost savings.

For example, let's say your company spends \$100,000 a year on office supplies like paper and pens.

Upon further analysis, you might find that \$70,000 is spent on high-end stationery while only \$30,000 is spent on pens and other low-cost items.

This would mean that 70% of your spending is going toward one type of product—in this case, stationery—and 30% is being spent on other types of office supplies.

This is an example of how the Pareto Principle can be applied to spend analysis; by focusing your efforts on reducing costs associated with stationery purchases, you could potentially save more money than if you were trying to reduce all office supply costs equally.

## How Pareto Analysis Works?

In a nutshell, Pareto analysis works by sorting data into two categories: “vital few” (which refers to those items or services that produce most of the value) and “useful many” (which refers to those items or services that produce little value).

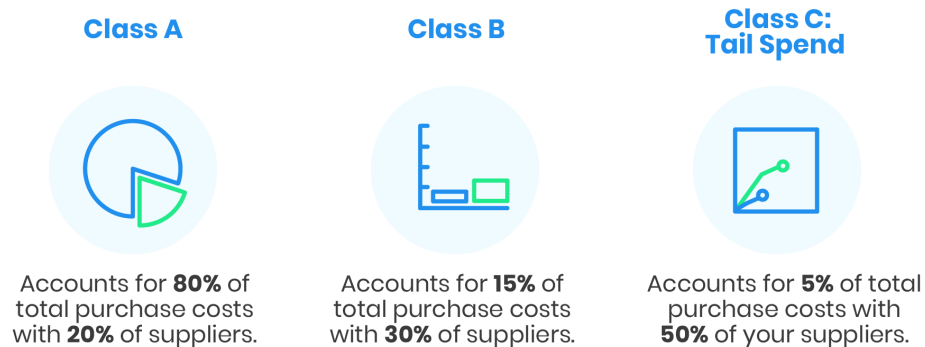
Using ABC Analysis:

- **Class A:** These purchases account for 80% of your total cost of purchases for 20% of suppliers.
- **Class B:** These purchases account for 15% of the total cost of purchases

for 30% of suppliers.

- **Class C:** Tail Spend: These purchases account for 5% of your total cost of the purchases for 50% of your suppliers.

## ABC Supplier Analysis



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For example, if an organization spends \$1 million on supplies each year and finds through Pareto analysis that \$800,000 of that amount is being spent on just 20% of suppliers, that 20% of suppliers should get special attention because they are producing the greatest value for money.

Similarly, if an organization finds through its spend analysis that only 10% of its products are generating 90% of its profits, it may make sense to invest more resources into marketing or researching those products while cutting back on other products with lower returns.

## The Benefits of Conducting a Pareto Analysis

Conducting a Pareto Analysis in procurement provides numerous benefits for organizations.

Not only does it allow companies to quickly pinpoint areas where they could save money without sacrificing quality or value, it also gives them insights into their

customer's needs and preferences, so they can better tailor their offering accordingly.

Additionally, since it requires minimal effort and resources compared to other cost analysis methods, it has become a popular choice among many businesses looking for ways to optimize their budgeting process.

Pareto Spend Analysis is an incredibly useful tool for optimizing supply chain management processes, reducing costs, and improving overall efficiency.

By leveraging this approach to analyze spending data across various categories, such as supplier type or product category, businesses can quickly identify their highest value suppliers while also uncovering potential cost savings opportunities.

Ultimately this leads to smarter decision making when it comes time to purchase goods or services from vendors - resulting in improved ROI while still maintaining high-quality standards throughout the process.

Procurement professionals should take advantage of Pareto Spend Analysis whenever possible to maximize savings and improve performance in their supply chain management initiatives.

While the main goal is to reduce costs and improve sourcing, it can also help improve supplier relationships, giving your organization a competitive advantage.

## **How to Conduct Your Own Analysis?**

To start your own analysis, choose what you're going to look at, then collect your data.

For instance, let's say you want to look at suppliers' late deliveries. In this case, you'll want to collect:

- All suppliers
- All the suppliers' deliveries over the last year.

Use an Excel spreadsheet to create a chart and help you with the math.

Create a table with:

- Supplier Name
- Total Deliveries
- Late Deliveries
- Percent Late
- Cumulative Percent Late

Once you've collected your data in the chart, sort the table in descending order.

You'll want to look at the Cumulative percent late column in this case, drawing a line at 80%.

From here, you'll see the items that add up to 80% are the primary cause of your issues, while those that fall between 80 and 100% are not as important.

## **Practical Applications of Pareto Analysis**

Once you've identified which products are driving the highest costs in your supply chain, it's time to start looking for ways to reduce those costs without sacrificing quality.

Here are some practical applications of pareto analysis in procurement:

### **▪ Negotiate Prices with Suppliers**

Companies can significantly reduce their purchasing costs over time by working directly with suppliers to negotiate lower prices for high-cost items to improve your bottom line.

It's important to remember that price negotiation isn't always about getting a lower price; often, suppliers may be willing to offer discounts or free shipping as part of a deal, which can also help reduce expenses in other areas.

### **▪ Consolidate Suppliers**

Supplier consolidation and consolidating orders helps streamline delivery processes and eliminates time wasted coordinating multiple shipments for various items from different suppliers.

A balance needs to be struck between supplier rationalization and ensuring you have flexibility and backup in place for key supplies.

Consolidating orders allows companies to save money by cutting out excess labor costs associated with managing multiple orders at once and reducing inventory overhead expenses since fewer items will be needed in stock at any given time due to fewer orders being placed frequently throughout the year.

## • **Utilize Automation**

Automation technologies like robotic process automation (RPA) help streamline cumbersome manual processes related to ordering and invoicing so companies can save time and money while maintaining accuracy in their transactions.

RPA also helps ensure compliance with contractual agreements since it reduces human error and improves accuracy when tracking orders against agreed-upon terms between buyers and sellers.

## • **Leverage Data Analytics**

Data analytics tools provide insights into purchasing patterns that allow companies to monitor supply chain performance more closely so they can make informed decisions around pricing strategies or supplier partnerships based on real-time information about what customers are buying when they are buying it, and how much they are paying for it.

Leveraging data analytics tools also help companies identify potential cost-saving opportunities, such as consolidating orders across different departments or negotiating better deals with certain vendors who may have better prices than others for certain goods or services.

## Practical Ways to Use Pareto Analysis in Procurement



Negotiate Prices with Suppliers



Consolidate Suppliers



Utilize Automation



Leverage Data Analytics

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## Tips for Conducting a Successful Analysis

When conducting a successful Pareto Analysis there are several key tips to keep in mind:

### • Set Clear Objectives

Before starting your analysis, make sure that you have clearly identified your objectives, including the metrics you'll use to measure success.

This will help ensure that you stay focused on these objectives throughout the process and don't get sidetracked by other data points.

### • Make Use of Data Visualization Tools

Visual aids such as graphs and charts can be extremely helpful when conducting a Pareto Analysis as they make it easier to identify patterns and trends in the data.

Additionally, these visual tools can be helpful when presenting your findings to stakeholders who may not be familiar with complex data sets. And that's where the Pareto chart comes into play.

A Pareto Chart is a visualization tool professionals employ to assess how

much a result or effect comes from a particular cause.

This powerful chart uses relative frequencies on its vertical axis, allowing metrics experts to analyze certain causes more deeply than an ordinary bar chart could.

The horizontal axis underlying the chart ranks data from largest to smallest values in order of importance, providing you with essential information about how particular causes shape an outcome.

When used correctly, this valuable tool can help metrics experts discover deeper trends in data sets and unlock hidden solutions for complex problems.

## • **Test Your Results**

Once you have identified potential solutions based on your analysis, it's important to test them before implementing any changes so that you don't introduce any unintended consequences into the system.

Testing allows you to validate your assumptions and ensure that any proposed solutions will result in positive outcomes before putting them into practice.

# **How Pareto Analysis Helps Your Procurement Strategy?**

By leveraging Pareto analysis with data analytics tools and automation technologies, businesses can gain valuable insights about their supply chain operations to make smart decisions around cost-cutting initiatives without sacrificing quality or customer service levels.

Through careful monitoring and analysis of spending habits over time using these techniques, businesses can reap significant long-term benefits in terms of cost savings while still providing excellent value for their customers through improved efficiency across their operations.

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