Spend Forecasting: How and Why You Should Do It

In procurement, as in so many other fields, today's "latest and greatest" technology has a decidedly shaky perch at the top.

And with digital transformation changing so many areas of business at a faster rate than ever before, procurement teams need to review the technologies they rely on to compete, thrive, and grow.

Deep data analytics, for example, have received much attention since the turn of the 21st century, providing detailed, real-time access to historical spending patterns and improving decision making through iterative improvements and adjustments to challenges such as seasonality.

But it's not just where you've been, but where you're going, that has value for today's strategic procurement pros.

Spend forecasting blends analysis of historical data with forward-looking forecasting processes and business intelligence from a variety of sources.

It helps decision makers achieve a much broader and deeper information set they can use to optimize the supply chain, slash costs, and make truly strategic spend decisions, as well as seize opportunities for greater process optimization, efficiency, profits, and overall organizational value through lower total cost of ownership (TCO) for every purchase.

What Is Spend Forecasting?

Every company wants to get the biggest possible value for every dollar they spend.

Traditionally, knowing the ebb and flow of a typical year's spend could, in a steady economy, provide procurement pros with a rough idea of what to expect in the years that followed.

Of course, sudden changes in the market, the loss of a key supplier, or disasters both natural and man-made could easily throw a spanner in the works, and so, as information became both more plentiful and easier to corral, organize, and manipulate, both procurement analytics in general and spend analysis in particular became both desirable and commonplace.

In the quest to transform data into useful insights, *descriptive analytics*, i.e. analysis of current and historical data, provided organizations with a radically improved method for spend forecasting.

With descriptive analytics, companies could build a set of performance data or spend data from a given time period, "slice and dice" it however they liked, and identify patterns that could be leveraged to create basic forecasts and achieve financial and performance improvements.

This might include a focus on tail spend analysis, for example.

This was a considerable improvement over manual methods, which often involved months of painstaking analysis, combination, and recombination just to identify (for example) the most strategic opportunities to purchase essential raw materials with high seasonal demand in a specific category.

Worse yet, given the amount of time and labor involved in harvesting them, these insights might have an extremely limited shelf life before the next analysis period was set to begin.

Descriptive analytics *also* greatly simplified data categorization and trend analysis for the organization as a whole.

This made capturing or creating value through process optimization (e.g., automating procure-to-pay in order to reduce purchase order and invoice lifecycles and achieve value through increased productivity, accuracy, and cost reductions) and supplier relationship management (e.g., adjusting spend on categories where the bulk of purchases went to non-optimal vendors) much easier.

However, descriptive analytics have their limits as a forecasting tool.

They're focused on spending patterns from the present and the past, and, barring the addition of information from other sources, provide only a basic roadmap for spend in the short-term future.

Spend Forecasting Bridges Past and Future

Enter *predictive analytics*, an enhancement to data management paradigms designed to assist with the forecasting process.

These analysis tools draw from a wide variety of current and historical data sources to create detailed and specific strategies for spend, based on a variety of factors, including:

- Cost drivers such as materials used, product complexity and components required, production labor, and transportation, as well as indirect costs such as administration and research and development (R&D)
- Market intelligence, including ongoing consumer behavior trends, competitor behavior, sustained or unusual supply chain disruptions (e.g., the COVID-19 pandemic, the Amazon rainforest fires, etc.), and industry, labor, and governmental regulatory changes.
- Economic factors, such as currency valuation, exchange rates, and interest rate adjustments.
- *Demand forecasting*, i.e. determining the nature of demand for materials, goods, and services purchased, and making strategic sourcing decisions based on the best balance of price, availability, and lowest possible total cost of ownership.

Spend forecasting leverages these data management and analysis tools not just to help procurement teams snatch up raw materials, goods, and services at the right prices from the right vendors at the right times, but to guide the organization more effectively as a whole.

And, used in tandem with other emerging technologies such as artificial intelligence and process automation, the spend forecasting process allows businesses to uncover and put insights to use while there's still plenty of time to do so.

Beyond supply chain optimization, strategic planning, and internal process improvements, spend forecasting can:

- Improve cash flow analysis and forecasting.

- Help management develop new products or innovate existing ones based on market data and consumer demand.
- Identify and take advantage of long-term strategic spending opportunities that provide not just cost savings, but competitive agility and resilience against market fluctuations and supply chain disruptions.

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Putting Spend Forecasting to Work

Once you understand the components of spend forecasting, it's time to explore *how* you can apply this blend of business and market intelligence, trend analysis, and spend analysis for the betterment of your business.

The addition of business intelligence tools to the mix makes it much easier to achieve the primary goal of spend forecasting: detailed, accurate, and strategic purchasing across multiple future financial periods, supported by decisions you make today.

Let's take a closer look at four key components of spend forecasting:

1. Demand Forecasting

Whether it's raw materials or the goods and services you rely on for the "business of doing business," every purchase is subject to demand.

Strategic planning and smart sourcing decisions require a clear understanding of how that demand affects each category of spend and the items within it.

Market research, industry and governmental intelligence, and direct analysis will help you predict the level of demand (flat, growing, high) and the expected or absolute difference in price per unit over time (i.e., the *price differential*) for a given period.

This analysis helps you identify the raw materials, goods, and services that will likely increase in price, demand, scarcity (or all three!) and leverage economies of scale to hedge against the coming price hikes.

This creates value and lowers TCO in three ways:

1. Providing immediate savings over future prices.
2. Boosting future cash flow and profits through cost avoidance.
3. Providing opportunities to optimize the supply chain by purchasing essential raw materials at today's more favorable price and providing those materials to suppliers to lower costs. For example, if your products require copper wiring, you could purchase copper in bulk, provide it to your wire suppliers in bulk, and eliminate the materials cost charged by those suppliers.
4. Balancing actual need against scarcity, demand, and price. For example, let's say your production process requires a machine with expensive filters that have a six-month lifecycle. Analysis indicates the price is likely to increase to $12,500 over last year's price of $10,000. It doesn't make sense to tie up $120,000 in capital buying a dozen at today's price to avoid the extra $30,000 you *might* spend down the road—especially if you only use an average of two filters each year and whatever equipment you buy in years to come may not be compatible with today's model.

2. Cost Forecasting

Businesses competing in today's global market are awash in a seemingly bottomless ocean of big data from myriad sources—and since sourcing decisions don’t happen in a vacuum, savvy procurement teams can filter and refine these data streams to mine intelligence related to future costs.

Diving deep into forecasts from several key areas can help you identify areas where costs are on the rise (encouraging timely sourcing) and where they’re dropping (giving you breathing room and time to balance purchases against cash flow needs).

These areas include:

- Current market pricing.
- Commodity pricing forecasts and trends.
- Energy and transportation cost forecasts and technological trends.
- Labor forecasts and trends.

Analyzing market trends is just the beginning.

Deep cost forecasting, performed at the category level, lets you develop cost models across the board and identify which categories of materials, goods, and services should be sourced when to achieve optimal results.

3. Currency Forecasting

Spend forecasting is a complex machine, with many interlocking cogs that can set even the best of sourcing plans askew.

Consider currency forecasting.

The most artfully negotiated contract, the best exclusive multi-year lock on raw materials pricing, the most favorable shipping terms…all can be thrown into chaos if you don’t factor in the intricate dance of exchange rates and valuation.

In the global marketplace, the right currency is as important as the right terms, price, and quality.

If you're contracted to buy Japanese goods in U.S. dollars, but international economic turbulence causes the dollar to sink, or the yen to spike, the bargain pricing you secured for an entire year may not be quite so alluring in six months.

Adding economic and currency trend analysis and forecasting to your spend forecasting benefits your organization in several important ways:

- More accurate and agile cost forecasting so you can make short-term and long-term sourcing decisions with confidence.
- On-demand, real-time analysis and forecasts let you adjust your sourcing decisions monthly and quarterly as well as yearly to anticipate or navigate economic or supply chain disruptions.
- Diversify your sourcing by category to ensure you're extracting maximum value from key suppliers for your most important categories, and minimizing resources dedicated to fine-tuning less critical ones.

4. Invoice Analysis

If you've worked in procurement, accounts payable, or both, you're probably familiar with the many ways in which invoices can create "leaks" in your finely-crafted value generation scheme.

Duplicate payments, late payments, lost discounts, invoice fraud…add in the costs of labor for manual three-way matching, data entry, and chasing exceptions (along with the potential damage to supplier relationships), and it's easy to see that, without proper management, invoices can definitely cost you big in both immediate costs and lost value.

Of course, if you implement a complete P2P solution like Planergy, process automation (including automatic three-way matching), a closed purchasing environment, and advanced analytics nip these problems in the bud.

You capture more discounts, eliminate rogue spend and fraud, and free up your team to focus on strategic tasks—lowering costs and plugging the leaks in both your revenue and value streams.

But what you may not realize is, those same spend analysis tools can help you use invoices for spend forecasting.

How? Well, for one, a sudden spike in invoices from suppliers outside the system (or, depending on your internal controls, a spike in requests to add new suppliers to the system) can indicate a need for new materials, products, and services.

Invoices without a corresponding PO are a flashing neon sign that can indicate not just the need for new additions to your supply chain, but opportunities to pursue new strategic partnerships (or forge stronger ones with existing vendors who can meet your needs).

In addition, any unusual or unexpected purchasing behavior that falls outside existing spending patterns can also provide an opportunity to revisit your other analyses—cost, currency, demand—to identify opportunities to integrate these new categories into your supply chain management, business continuity management, and overall business process management plans.

Spend Forecasting Can Help You Chart a Course to More Strategic Spending

Managing today's spend is just a single step on a longer path illuminated by the insights discovered through spend forecasting.

Embracing the power and potential of tech tools that let you analyze, review, and refine your strategic spend and financial planning helps ensure your entire organization is buying with an eye toward the highest possible value, the lowest possible TCO, and nimble competitive footing in an uncertain global economy.

What's your goal today?

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