Order to payment

More and more, this process distinguishes winners ◆ The challenge is to link material, information, and monetary flows ◆ But international organizations cannot be reengineered only from the top ◆ Building "microcosms" with an action perspective may be the answer

Ask top managers where the order-to-payment process lands among their strategic priorities, and most will tell you it doesn't even make the list. Often, order to payment is delegated to a middle manager with responsibility for operations effectiveness or logistics management. But as companies realize that strong brands and good products are no longer enough to ensure success, and as they begin to see limits to growth in their primary (and even secondary) channels of distribution, the strategic importance of the order-to-payment process is growing.

Most industries are experiencing intensifying cost competition, rising customer sophistication and fragmentation, and converging product performance. Product life cycles are shrinking, and demand is becoming less and less predictable. In such an environment, delivery performance and customer service are becoming as critical as product performance and brands. The way companies make, adapt, sell, and distribute their products is turning into a major source of competitive edge.

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Consider Benetton, which changed the game in fashion retailing – not through its designs, but through a completely new approach to making and distributing clothes. Fast, responsive, and accurate, its order-to-payment process allows it to compete with higher margins than the rest of the industry.

Or look at Procter & Gamble and its arrangements with Wal-Mart in the United States. The retailer's electronic link to P&G automatically sends off a replenishment order as soon as an item is sold. Not only does this improve the effectiveness of the order-to-payment process, boosting profits for the two companies to share, but it has also created a special relationship between the partners. When a company's superior delivery service makes it the preferred supplier, it may reap significantly more volume than the second or third supplier.

Improving order to payment need not require years of process mapping and exhaustive implementation efforts

Despite the growing importance of the order-to-payment process, few companies have been able to capture its full potential. The thought of long reengineering programs and big systems investments understandably puts many managers off. But improving order to payment need not require years of process mapping and exhaustive implementation efforts. In our work with more than 25 companies from a variety of industries during the past two years, we have developed an approach that attacks the problem in microcosms. With the new approach, an improvement program will no longer take several years to deliver impact.

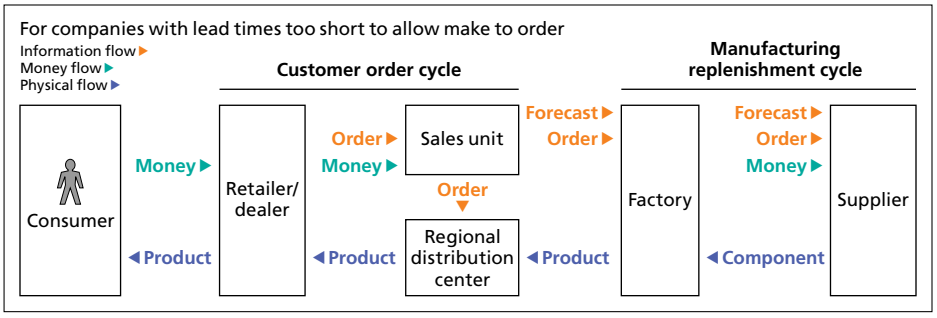
Moreover, the microcosm approach acts directly on the levers that influence return on capital, namely revenues, costs, and capital employed. Companies adopting it have enjoyed impressive results, with revenue increases of between 5 and 15 percent, total costs down by 8 to 12 percent, and capital requirements cut by as much as 50 percent, mostly through reduced finished goods inventory and work in process. Better still, this kind of effort often leads to the identification of new channels of distribution – channels that may open up whole new markets or market sectors.

The order-to-payment process

"Order to payment" may be defined as the material, information, and monetary flows that run through a company from raw material to end customer (Exhibit 1). The process thus incorporates most business activities except brand building, after-sales service, and new product development. In contrast, the concept of the supply chain is typically much narrower – focusing exclusively on the material flow from factory gate to warehouse or customer door is just one example.

Exhibit 1

The order-to-payment process



Many companies have devoted substantial process-oriented initiatives to manufacturing and logistics. Yet few have been able to capture the strategic potential of the broader order-to-payment process. This potential can be considerable, especially for industries with tight profit margins and demanding customers with disparate needs, or those with rapidly changing requirements and short product life cycles.

One example of a company with tight profit margins in a competitive industry might be a white goods manufacturer. Whether such a company has three or nine weeks' total finished goods inventory in its system can make a considerable difference to return on capital. A PC manufacturer, on the other hand, has to contend with rapidly changing market requirements, high growth, and heavy penalty costs for stocking obsolete products or missing a market upturn. In consumer goods industries in general, many companies have up to 5 percent stockouts – and nearly as many lost sales.

Improving order to payment can also secure less tangible prizes. A superior order-to-payment process can position a company as preferred supplier, a critical asset in many industries. Understanding customer segments – and the most appropriate order-to-payment process for each – can open up new strategic options too. Dell Computer became one of the world's ten largest PC manufacturers not by having the best products or the strongest brand, but by establishing a build-to-order mail-order service as a new, cost-effective distribution channel for PCs.

Spotting the potential

How can you identify the latent potential in your own order-to-payment process? The first test is to look for common symptoms of underperformance like low delivery reliability, stockouts, and long lead times. Companies with an inferior order-to-payment process also have trouble responding to unusual or changing customer demands, and making minor design changes without incurring lengthy and costly delays. Other typical

telltale features include high inventory levels, large write-offs of obsolete products, perennial arguments and finger-pointing between functions, and a lot of time spent fire-fighting.

In companies exhibiting these symptoms, most customers and segments are served through the same basic structure. Often, this means that the most exacting or complicated customer sets the cost and service standard – at the expense of other customer segments and the company as a whole. Or it means serving demanding customers poorly, and ultimately losing them. In such companies, there is usually only a limited awareness of the true cost differences involved in serving various customer segments, and of the effects on the total system of optimizing the performance of a single function (for example, focusing on full truckloads, which may delay delivery).

Improvement programs fail for three main reasons: wrong solutions, wrong incentives, and wrong approach

Moreover, a company with a poor and inflexible order-to-payment process will be slow to adjust to market upturns and downturns. When demand falls, it will be stuck with high cost levels and even higher inventories. When the market picks up again, it will be unable to meet demand, losing share because of its inability to respond quickly.

But diagnosing an underperforming order-to-payment process is easier than figuring out how to fix it. In our experience, improvement programs fail for three main reasons: wrong solutions, wrong incentives, and wrong approach.

Wrong solutions

Weak order-to-payment processes seldom denote lack of effort. Most companies are well aware when their service and distribution performance doesn't live up to expectations – and if they aren't, their customers normally tell them. First attempts at overhauling the process tend to focus on boosting efficiency and building capability within individual functions.

Sales works on improving forecasting techniques, streamlining the product portfolio, and adhering to ordering procedures. Manufacturing tries to achieve stable production volumes, to manufacture to schedules and forecasts, and to reduce raw materials inventories and work in process. Distribution looks to cut transport costs by working on load factors and optimizing warehouse networks.

In the next wave of initiatives, companies may work on the handoffs between key functions. They encourage sales and manufacturing to talk to

one another so as to break old habits of second-guessing and working from different data and forecasts. Tools such as MRP II and sales and operations planning frameworks are frequently used in this phase.

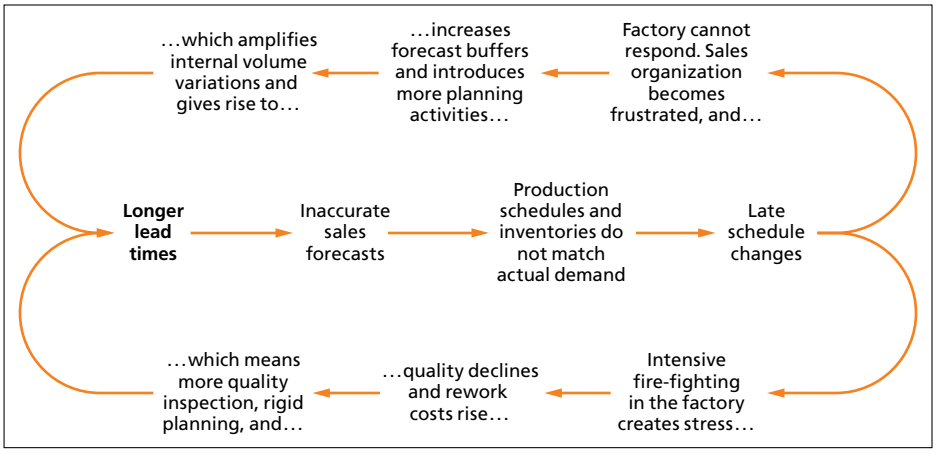
Measures like these may address the symptoms but, unfortunately, they do not get at the real causes of a poorly functioning order-to-payment process. More often than not, the root of the problem lies in the fact that a business is operating with and reacting to information that does not reflect what is actually going on in the marketplace. Many of the signals that trigger activity in the average manufacturing company are internally generated, distorted, and inaccurate. They represent an attempt to model and forecast a future that is increasingly unpredictable.

Signals that trigger activity in the average manufacturing company are often internally generated, distorted, and inaccurate

The main culprit is the long lead time built into most companies' order-to-payment process (Exhibit 2). Long lead times breed inaccurate sales forecasts; inaccurate sales forecasts mean that production schedules and inventories do not match real demand. As a result, late changes have to be made to orders in the factory and warehouse to try to prevent stockouts and missed opportunities.

Exhibit 2

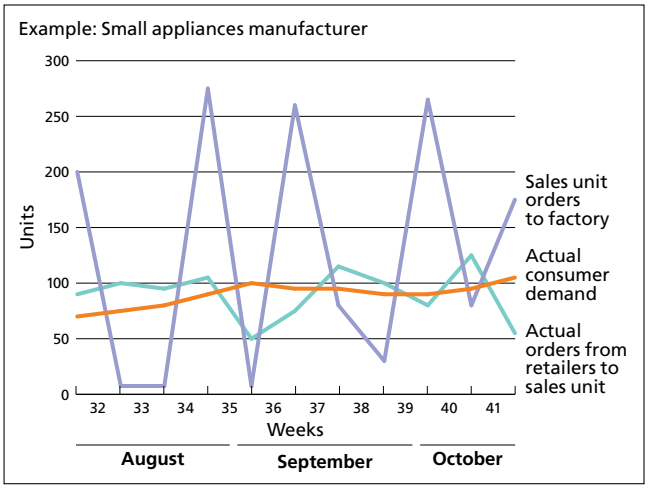
Lead-time dynamics



When manufacturing fails to respond at short notice, the sales organization gets frustrated, exaggerates its orders to build in a safety margin, and introduces extra planning activities. Internal signals become still more distorted. Manufacturing is encouraged to extend lead times and introduce frozen planning periods for orders from the sales units. Frequent late changes to production schedules give rise to intensive fire-fighting, poorer

Exhibit 3

Internally generated volume fluctuations



quality, additional quality inspections, and the building of yet more lead time into the process.

These dynamics feed on one another and prevent most companies breaking out of what becomes an increasingly vicious circle. Exhibit 3 shows how far internally generated orders can differ from actual consumer demand in the case of one company, a small appliances manufacturer.

The solutions we are proposing address the root causes of this problem. Rather than improve forecasting, we try to limit the need for it by short-circuiting the order-to-payment process. Rather than compromise on the product portfolio, we try to minimize the costs of differentiation and maximize flexibility.

In the long run, it is futile to work against customer demand or attempt to predict how it will change. Over time, the winners will be those companies that are able to adapt to a variable market quickly and continuously, and at the lowest cost.

Wrong incentives

Most companies' behavior is driven by incentives and norms that are diametrically opposed to the kinds of actions required to tackle the root causes of a poor order-to-payment process. Functionally based objectives encourage managers to optimize individual parts of the order-to-payment process, often to the detriment of the whole. Sales is usually preoccupied with brand awareness and promotional activities, contribution margin, and market share, which may or may not correspond to maximum total profit. Logistics typically focuses on load factors and transportation costs. Manufacturing is judged by its unit costs, labor productivity, raw materials inventories, and first-pass parts quality.

Seldom is it clear who is responsible for the total cost of serving a particular customer segment, or for the overall quality of that service. No one has the necessary integrated perspective to make important tradeoffs (such as higher unit transport costs against faster, more punctual delivery and lower

finished goods inventories), or to be accountable for customer or channel profitability. The structure of most companies is such that these issues come together only at CEO level – and rare is the CEO who has the breadth (and detail) of skill, the experience, and the time to deal with them effectively. Even in these exceptional cases, a lack of information transparency across the order-to-payment process may well preclude effective action.

Wrong approach

The third problem in exploiting the potential of the order-to-payment process is the approach. Most companies opt for some kind of reengineering program. Though the intentions behind these efforts are good and the theories underpinning them usually solid, over 70 percent of all reengineering initiatives fail to deliver real bottom-line impact. Such programs are absorbing at the outset, but peter out as fatigue and disappointment at the lack of results set in.

Despite good intentions, over 70 percent of all reengineering initiatives fail to deliver real bottom-line impact

The difficulty lies in the way most of these programs are organized and conducted. They tend to begin with months of process mapping, followed by a design phase where the new processes and structures are modeled and potential savings are estimated. Implementation is often driven by a few pilots, which then give way to a broad rollout through existing functions and units.

This approach has three important flaws. First, in large international organizations, it is next to impossible to design the right solutions from the top down. Second, the directives – usually based on experience from pilots – that are sent down the line during implementation seldom have full effect. Despite extensive efforts to train frontline staff and key managers, the understanding and skills required for implementation are often lacking. Third, management has to make a huge upfront commitment to the redesign without any reliable indication of its probable results.

Breaking through in microcosms

Breaking through these barriers calls for a new approach. Our answer is to attack the problem via "microcosms" – miniature versions of the company as a whole.

A microcosm is a complete end-to-end slice of the business, from raw materials to customer delivery. One example might be the sales of a specific product group to a particular customer or segment. The microcosm tracks the entire flow backwards from the customer through the sales organization,

distribution and logistics, and part or all of the factory, ending at the key raw material suppliers (Exhibit 4).

Exhibit 4

A microcosm flow

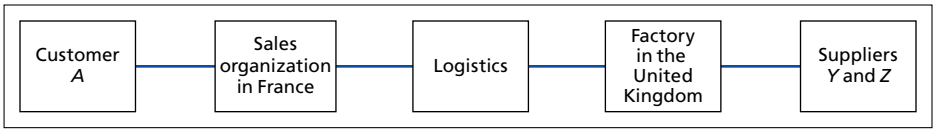
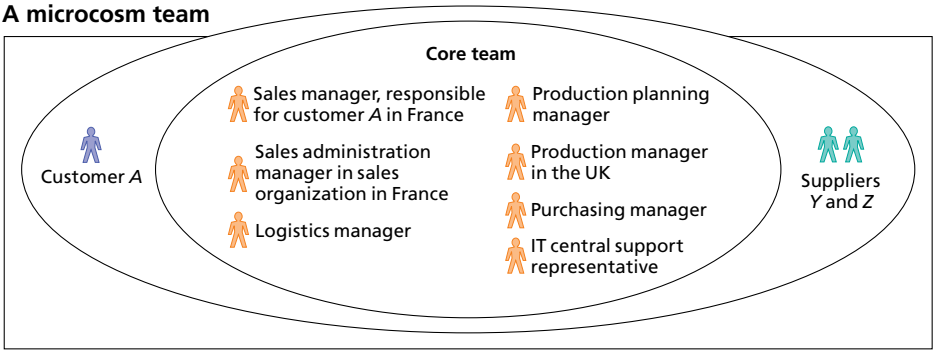


Exhibit 5

A microcosm team



When a company opts for this approach, it sets up a microcosm team with line representatives from all key activities in the order-to-payment process (Exhibit 5). Participants might include managers from sales, logistics, production planning, production, purchasing, and IT support. The team is charged with creating real economic value for the chosen customer or segment. It begins by asking such questions as: If we were serving only this customer segment with these products, how would we choose to operate and organize ourselves? How far do we need to drive improvements to create economic value for this segment? What support do we need from our suppliers and distributors?

> Being part of a microcosm team is not like anything most line managers have experienced before

The aim is to design, test, and implement a radically improved structure within four to six months. The process is fast, iterative, and demanding. Significant bottom-line impact should be visible for the entire company in six to 12 months. By contrast, most reengineering efforts take a year or so just to map processes and design solutions, and another two or three to achieve intended savings or improvements.

A microcosm is not a pilot. A pilot is a way of testing a concept before a company embarks on a full-scale rollout. With microcosms, there is no rollout. Microcosm teams are launched in waves covering successively larger parts of the whole business.

Even if top management begins to discern which solutions will work and what potential can be realized, each microcosm team is allowed, within a common guiding framework, to venture out on its own voyage of discovery. This is essential if broad insights and ownership are to develop in the line. Moreover, when a team is no longer constrained to consider the company as a whole, but can focus instead on a particular customer or segment, substantial energy and creativity are released. The number of microcosms a company requires will depend on its size, spread, and complexity. Anything from a handful to 20 or 25 might be needed before the whole company has been covered.

As the program evolves, key people from early waves can be employed as facilitators in subsequent teams, making the effort self-supporting at a relatively early stage. Risks will consequently be much lower than in a conventional reengineering approach, with its high profile and wholesale launch across an entire organization.

Team members are forced to step out of their functional boxes and leave their comfort zones behind

Although individual microcosms are fairly autonomous, some centrally managed initiatives usually prove necessary. New and radical solutions developed by the teams will challenge the company's current incentives, work processes, and perhaps even organizational structures. The resulting changes will need to be managed in an integrated fashion so as to provide clear, cohesive direction and avoid suboptimization for the company as a whole. Where shared facilities such as factories, warehouses, and transportation are concerned, a central group may need to reconcile the different solutions proposed by separate microcosm teams.

In our experience, however, there is much less need for corrective measures than one might expect. Genuine shared bottlenecks are rare, and often relatively easy to resolve over time. It is the central team's job to remove obstacles quickly and to drive any efforts that are beyond the control of individual microcosm teams.

Being part of a microcosm team is not like anything most line managers have experienced before. The pace is challenging; the pressure to perform is real; and team members are forced to step out of their functional boxes and leave their comfort zones behind. Once accepted, this will become their chief source of energy and creativity.

People who have never talked about their business in a holistic way begin to see how it hangs together and where value is created and destroyed. They come to realize the effects their actions have on the rest of the system. Teams start to "own" their customers.

Here again, the approach differs from that of a typical reengineering program. Teams are charged not with recommending how processes can be improved, but with actually making changes happen. However, they do so in a context of manageable scale – a microcosm.

Impact

The new approach has been successfully adopted by more than 25 pan-European companies to date. Several important insights have emerged.

Within a microcosm, every element of the order-to-payment process is redesigned around three basic principles: reacting to real market demand, responding to individual customer or segment needs, and acting on clear information transmitted through the entire value chain. Accordingly, the new process will embody more differentiation and a sharper focus on customers. For sales, this implies customer-oriented strategies, linking key account management and back-office services much more tightly to the order-to-payment process. This is likely to entail changes in organization, sales and merchandising configurations, and forecasting and order routines. At the factory, ordering is likely to increase in frequency from weekly or monthly to almost daily.

Microcosm teams have often identified new channels which in some cases have opened up entirely new markets

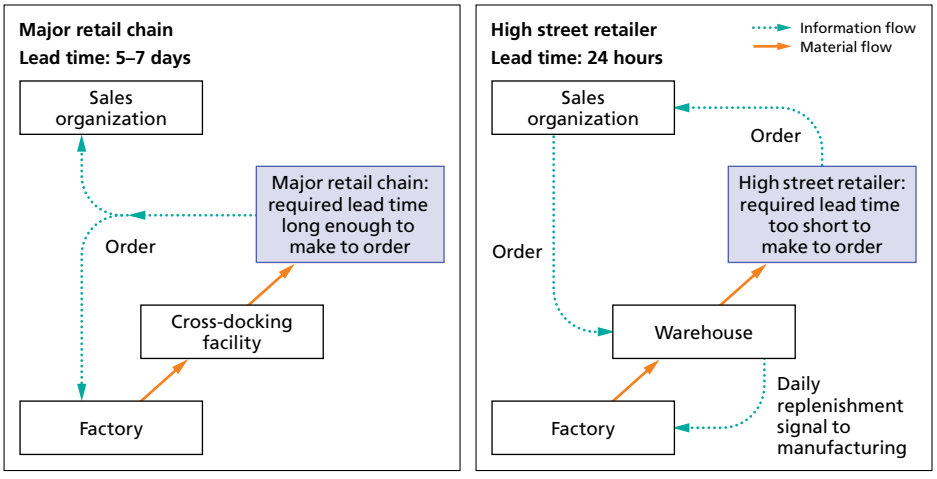
Logistics will also be transformed. Instead of spending its time optimizing load factors and transport costs, this function will tie the whole order-to-payment process together. Distribution reliability will improve; frequency will increase. Manufacturing will be reconfigured to build its volume and mix flexibility, allowing it to produce at very short lead times – and in response to actual sales information, rather than forecasts. At one consumer goods manufacturer, two different order-to-payment processes were set up: a make-to-order flow for larger retail chains that hold their own inventory, and a daily make-to-replenishment flow for high street retailers that do not want to hold inventory (Exhibit 6). Key suppliers will also become more fully integrated into the order-to-payment process, and they too will be required to plan their activities around real signals from the marketplace.

The results so far have been impressive. In addition to the return-on-capital improvements mentioned at the beginning of this article, microcosm teams have often identified new channels which in some cases have opened up whole new parts of a market or even, indeed, entirely new markets.

More important, attitudes, capabilities, and behavior have undergone perceptible changes. No longer merely paid lip service, the notion of

Exhibit 6

Examples of differentiated operating model of a consumer goods manufacturer



customer orientation has been driven much deeper into the organization, affecting not just the sales unit but also the factory floor. Suddenly, the factory is producing not to inventory, but for known customers, or at least in response to real sales signals.

Transparency of information is vital to such an approach; it also brings important benefits of its own. When everyone is working with the same data, much of the old departmental feuding disappears. Managers adopt a far more holistic outlook on business performance. Strategy is driven by an analysis of specific customer needs, translated directly into actionable performance requirements.

Microcosms are not for everyone. They are for solidly performing companies that aspire to be truly distinctive. Others can still make progress by streamlining individual functions or flows. A program based on microcosms lends itself to organizations that have already done what they can via conventional routes, and are looking to move to the next level in terms of cost, speed, and precision. Once they make the jump, they may also find themselves suddenly able to compete in channels and markets that were formerly beyond their reach.