

TREASURY SERVICES

Unleashing New Working Capital Potential with Order-to-Pay Automation

As organizations automate their order-to-pay process, many discover an unexpected and often unplanned benefit—the ability to optimize their working capital.

J.P.Morgan

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Order-to-pay automation is delivering valuable new business potential to corporate finance. Often, the impetus for order-to-pay automation is operational efficiency, driven by cost savings from eliminating paper and reducing headcount. The savings from optimizing working capital, however, can be even more dramatic—anywhere from five to 10 times the operational cost savings. When organizations discover this new business potential, order-to-pay automation emerges as a strategic corporate finance initiative.

This paper will examine the substantial working capital impact of order-to-pay automation on corporate finance. Our analysis will identify best practice approaches that can facilitate top-quartile performance, explain how you can achieve results by extending—not replacing—your existing systems, and document the results that leading practitioners are achieving today. We will discuss a modular approach in which you can start with e-payment or e-invoicing and subsequently expand your initiative to a comprehensive order-to-pay rollout. In addition, you will learn about a working capital optimization strategy that combines p-card settlement, early payment discounts and supply chain financing.

J.P. Morgan brings a unique perspective to this discussion. J.P. Morgan's Order-to-Pay service is part of a complete portfolio of treasury services solutions that enables straight-through processing without third-party risk. Single-use commercial card accounts, imaging of paper invoices for total invoice automation and supply chain financing are examples of J.P. Morgan's offerings that maximize the working capital potential from payables automation. These are key components of a comprehensive working capital optimization strategy that will be examined in this paper.



Overview of Working Capital

$$\begin{array}{|c|} \hline \text{Current Assets} \\ \hline \end{array} - \begin{array}{|c|} \hline \text{Current Liabilities} \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Working Capital} \\ \hline \end{array}$$

Especially in periods of economic volatility, this new way to manage working capital can provide the extra stability critical to the financial health of both you and your suppliers.

Working capital is a financial metric that represents the amount of day-to-day operating liquidity available to a business. Along with fixed assets such as plant and equipment, working capital is considered to be part of operating capital and is a measure of a company's efficiency and short-term financial health.

Working capital is calculated as current assets minus current liabilities.

Positive working capital means that the company is able to pay off its short-term liabilities. **Negative working capital** means that a company is unable to meet its short-term liabilities with its current assets—such as cash, accounts receivable and inventory.

Why is this important? Even a rudimentary understanding of working capital demonstrates how different business functions impact this critical measure.

For example, the treasury group looks for ways to achieve low-risk, high-yield returns on cash and to maintain the necessary cash flow to effectively run

the business. Procurement balances its efforts to reduce spend through favorable terms and contracts while improving supplier relations. Accounts payable looks to pay those negotiated contracts on time in order to capture early payment discounts while avoiding paying net-term invoices too quickly.

Each of these functions impacts working capital, making it a delicate balancing act. How a company manages the challenges of its payables and receivables is noteworthy—making both DPO and DSO critical metrics for corporate finance:

Days payable outstanding (DPO)

is the measure of a company's average payable period. It is calculated as accounts payable / cost of sale x 365. DPO is an indicator of how long a company takes to pay its trade creditors.

Days sales outstanding (DSO) is a measure of the average number of days a company takes to collect revenue after a sale has been made. A high DSO number shows that a company is selling its product to customers on credit and taking longer to collect money.

Extending payables may improve your organization's cash position, but it can place financial stress on your suppliers. When credit markets are tight, suppliers want to collect their receivables as quickly as they can.

Order-to-pay automation offers your payables organization new tools for managing cash while maintaining the controls over payables. Electronic invoicing, for example, streamlines the settlement cycle, automating the routing of invoices for rapid approval. With integrated electronic payment, you can maintain control while expanding your payables strategies.

For example:

- You can pay early to capture discounts that meet your acceptable hurdle rate¹ for cash use. (For example, 2% 10 Net 30 is equivalent to about a 36% APR.)
- You can pay past the discount date—but before the net-term date—to capture sliding scale or prorated discounts—a cash management option not possible with traditional discount terms.
- You can pay on the due date to preserve cash and maximize your return on float.
- You can establish a new term policy. For example, you can extend net terms from 30 days to 45 days to stretch DPO and increase float.

Taken together, these strategies can deliver what was once thought to be impossible: expanding both early payment discounts and DPO. Many companies are maximizing early payment discounts because automation provides new options for capturing them. For example, “dynamic discounting” (discussed later in this paper) is emerging as an attractive alternative source of cash for suppliers.

Toward the end of fiscal periods and especially in periods of economic volatility, this new way to manage working capital can provide the extra stability critical to the financial health of both you and your suppliers.



10,000	140,000	13,500
70,000	89,678	13,500
40,778	117,451	13,500
70,551	74,637	13,500
33,737	70,400	13,500
29,500	84,015	13,500
43,115	104,891	13,500
63,991		

New Potential for Optimizing Working Capital

With the right “levers” in place, your treasury organization can generate high-yield, risk-free returns from payables—while maintaining strict controls on both cash use and DPO.

One lever in this new approach is establishing terms’ policies and a hurdle rate that maintains or extends your DPO. For example, a hurdle rate of 18% requires early payment terms that deliver an annual rate of return of at least 18%, which is the yield on a 1% 10 Net 30 term. If you extend your standard term from 30 to 45 days, many suppliers will be motivated to offer a discount term that meets your required cash return. Your remaining payables will be stretched about 15 days, generating additional return on the float. For example, over 15 days, a 5% annual cash return would yield more than \$2 million in incremental float for every \$1 billion in cash balances.

Maximizing early payment discounts requires a supplier and spend analysis, which is discussed later in this paper.

The analysis will allow you to identify suppliers with the greatest discount potential and to develop a strategy to recruit and onboard those suppliers.

Another lever is the use of settlement cards as a means of expanding a p-card program. Many procurement organizations have implemented purchasing card programs that deliver enhanced controls while generating significant savings via rebates. Leading financial institutions offer single-use settlement cards that can be used in place of paper checks for settling high-volume, low-cost transactions. Making the switch from paper checks to commercial card settlement can lower costs, eliminate paper and significantly expand p-card rebates.

¹ Hurdle rate—the minimum rate of return that must be met for a company to undertake a project

As an alternative to the more conventional approach of simply stretching payables, a proactive approach of maximizing discounts that can maintain or extend DPO promises a significant new opportunity to improve management of working capital. Treasury and finance professionals find real value in adopting this new way of leveraging their A/P balances for working capital optimization.

Advanced Discount Capture

The football term “fourth and goal” means you have one last chance to score before the other team gets the ball. In business, there is a similar concept at the end of a fiscal period—what Michael Teach calls “the dash for cash”²—when firms make a final attempt to find cash tied up in their receivables and payables.

An emerging best practice that firms employ in this periodic “dash for cash” is dynamic discounting. Dynamic discounting provides your suppliers

with an opportunity to accelerate receivables in exchange for a discount on approved net-term invoices. A segment of your suppliers will have a greater need for cash and may be more willing to offer a discount in exchange for payment acceleration.

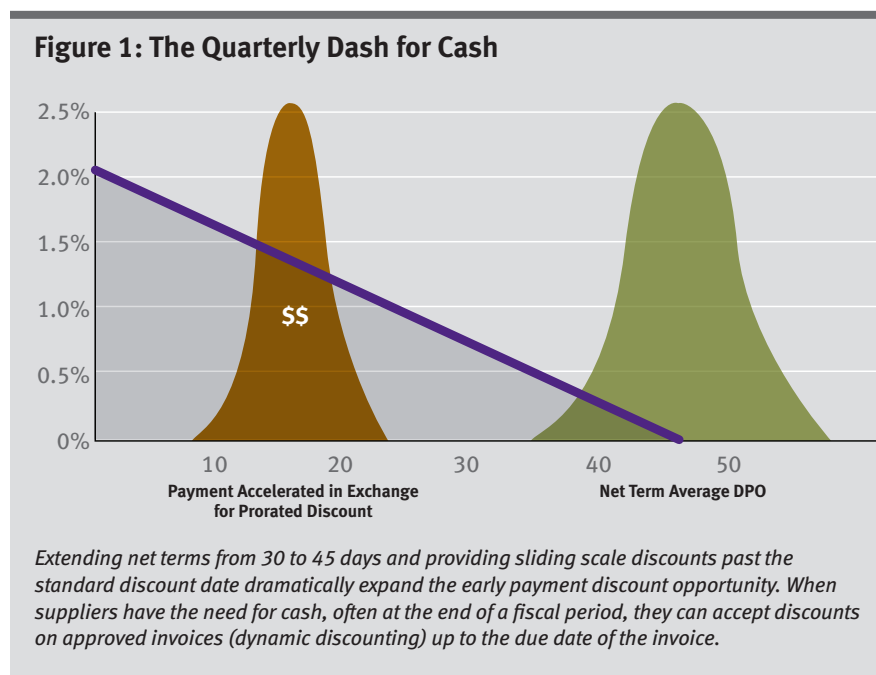
As Michael Teach pointed out, this demand increases at the end of fiscal periods. At the end of the third quarter of 2008, 14% of invoices in the paper and printing services category were dynamically discounted in the J.P. Morgan Business Settlement Network. This surge in use of J.P. Morgan’s Pay Me Now™ feature demonstrates that suppliers will leverage their receivables as an alternative source of needed cash.

Dynamic discounting is one of several advanced discount management best practices for organizations that have automated their payable operations. Other techniques for maximizing discount results include: supplier enablement for targeting, recruiting, onboarding and supporting

An emerging best practice that firms employ in this periodic “dash for cash” is dynamic discounting.

suppliers; and prorated discount terms for capturing discounts past the discount due date on a sliding scale. (For example, J.P. Morgan’s ASAP™ terms—2% 10 Net 30 ASAP.)

By following advanced discount management best practices, a buying organization can capture substantial savings from incremental discounts. J.P. Morgan’s Order-to-Pay clients that follow these best practices generally realize about twice the captured discounts compared to clients using e-invoicing alone.



Supply Chain Financing

Supply chain financing (SCF) is a financing option that uses third-party financing in place of a buying organization’s balance sheet to fund early payment discounts. This guarantees accelerated payment to those suppliers willing to offer an early payment discount.

As order-to-pay automation opens up new opportunities for discount management, interest in SCF programs is growing. You benefit by reducing spend on goods and services without leveraging your own cash balances, while your suppliers enjoy greater liquidity, flexibility and control over their receivables.

² Michael Teach, “Working Capital: Fourth and Goal,” CFO Magazine, November 2, 2007



Greater use of purchasing cards for settling approved invoices represents another lever for optimizing working capital.

Settlement Cards

P-cards are among the fastest-growing segments of the card business. By combining payments and financing, they are a natural fit for financial supply chain management. A recent survey of financial institutions with p-card programs indicates widespread support for purchasing or settlement cards.⁴ In addition, industry experts have long encouraged financial institution support of p-cards.

As referenced earlier, greater use of purchasing cards for settling approved invoices represents another lever for optimizing working capital. Today, with single-use card accounts, buyers can replace paper checks with p-cards to settle more transactions with card-accepting suppliers—all the while leveraging purchase order and invoice approval processes. Single-use cards have great appeal for organizations looking to expand their p-card programs to capture additional rebates, and the increase in average card transaction size reflects this interest. In addition,

the incremental rebates can be used to fund an order-to-pay automation initiative.

A good p-card program should accomplish the following goals:

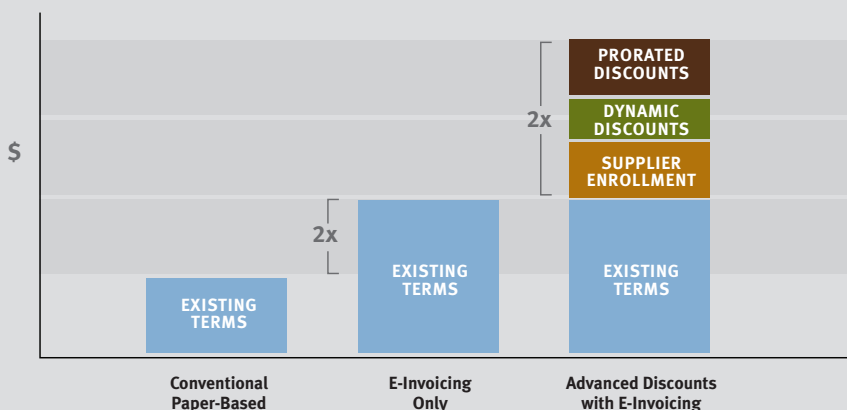
- Reduce the cost associated with vendor setup and processing invoices and/or payments
- Facilitate the efficient management of cash flow
- Increase the buying firm's rebate potential
- Measurably improve controls (policies and procedures as well as spend monitoring)
- Automate reconciliation and guarantee faster payment to vendors
- Provide global acceptance of the card

Working Capital Suite

Card settlement, early payment discounts and SCF are options that address the different requirements of your supply chain. Together, they represent an integrated solution suite for working capital optimization.

Segmenting and targeting your suppliers will determine how best to map settlement options to meet your working capital optimization goals. This will be discussed in the Supplier Management section of this paper.

Figure 2: Capturing 4x the Discount Savings with E-Invoicing and Advanced Discount Features



Whereas conventional paper-based processes might capture about 50% of pre-negotiated savings,³ invoice automation allows the capture of virtually every discount opportunity. Advanced discount features, however, enable a 4x or 300% increase over conventional approaches.

³ "Dynamic Payables Discounting and Supply Chain Financing," PayStream Advisors, 2008

⁴ "Corporate Payments and Financial Supply Chain: Which Banks Are Best," Financial Insights, 2008

Getting There: A Working Capital Road Map

Best practices for optimizing working capital include the following:



Paper-based payables mean processing delays—with the corresponding inability to capture discounts.

A recent Aberdeen Group study indicates that only 50% of early payment discounts are captured because A/P simply cannot process the paper fast enough.

A/P automation dramatically compresses the settlement cycles—from weeks or months down to a matter of days.

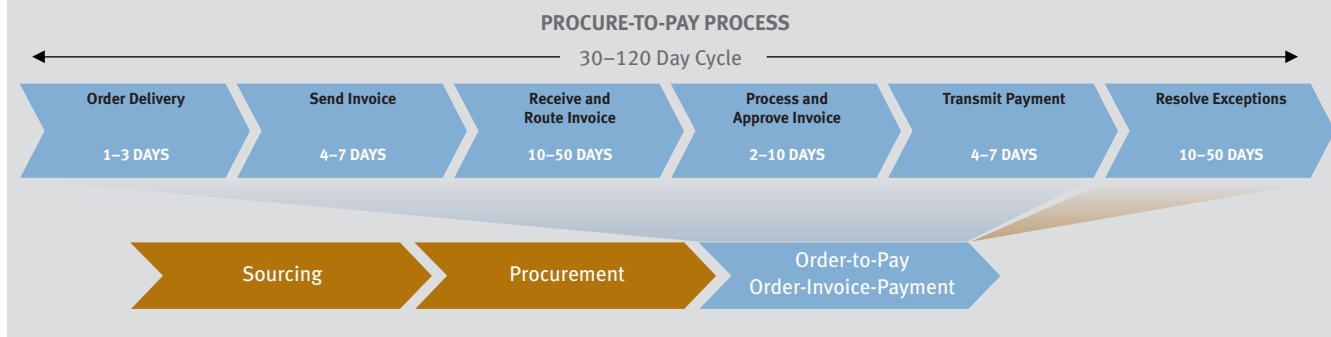
This unleashes valuable new potential to monetize early payment discounts that were out of reach. These discounts can drive measurable increases in net income and deliver lucrative cash returns.

Figure 3: Boosting Returns

	Float Model	Early Payment Discount Model
Value of Invoice	\$1,000	\$1,000
Time to Process Payment	30 days	10 Days
Real Savings	\$4.10	\$20
Short-Term Return	0.41%	2%
Annualized Return	5%	36%

Figure 3 shows comparable information for a firm operating in a typical payables environment in which a \$1,000 invoice, based on net 30 terms, is held for the full 30 days. Assuming an annual interest rate of 5%, the company realizes a 0.41% return for the 30 days of float. Compare this with an invoice that the buyer and seller have negotiated a 2% discount for payment made in less than 10 days (e.g., 2% 10 Net 30). That 2% discount works out to an annualized return of about 36%—many times greater than the more conventional short-term cash returns available today.

Figure 4: Automation Compresses the Settlement Cycle



Process Automation: Laying the Foundation for Working Capital Breakthroughs

Organizations have long regarded A/P as a tactical function within corporate finance and a low priority for business process improvement. With order-to-pay automation, however, you conduct the settlement of business transactions with your suppliers over a secure settlement network. Compressing the settlement cycle to a few days—and providing a supplier portal so suppliers can see invoice and payment status—creates a new paradigm for business settlement. Now you can mine hidden profits in your accounts payable balances to maximize early payment discounts and optimize working capital in ways never before possible.

Figure 4 illustrates the end-to-end business settlement process, from order delivery to payment, for straight-through processing of business settlement transactions. The impact of this effort extends well beyond accounts payable. Your treasury organization gains better cash forecasting and cash management. Greater visibility into the entire order-to-pay process helps avoid fraud and supports Sarbanes-Oxley visibility requirements. This can lead to significant savings, as a recent study showed 66% of corporate fraud occurs around the disbursements function.⁵

Improving the business settlement cycle also has a profound impact on procurement because efficient invoice processing can enforce discount terms in negotiated contracts. Guaranteeing on-time payment can further strengthen supplier relationships and better align procurement and A/P.

The proven benefits of A/P automation include:

- Provision of visibility and control across the procure-to-pay process
- 100% invoice automation, including imaging of paper invoices, to engage your entire supply chain
- Reduction of spend on goods and services
- Reduction of processing costs and management time spent on non-value-added activities
- Optimization of working capital including better management of cash flow/DPO

Supplier Management—Spend Analysis

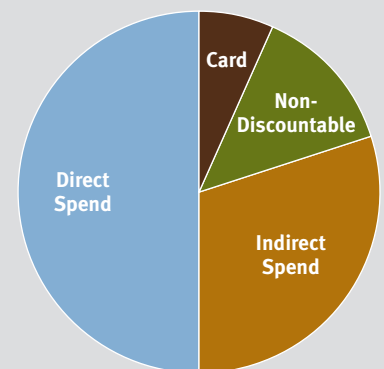
To ensure best results from a working capital optimization initiative, you must thoroughly analyze the state of your order-to-pay operations and supply chain. The objective is to develop a detailed plan for optimizing working capital that employs effective benchmarking and performance measurement metrics.

Spend analysis is a first step. To begin, evaluate your firm's priorities and then set specific goals for optimizing working capital.

Recognize that your firm's supply chain is not a homogenous entity but a mix of categories with shared requirements. Proper segmentation of suppliers and spend will help you target suppliers and supplier categories that maximize their participation in your program.

You should analyze data by supplier, identifying current payment terms, spend frequency and volume. You might begin by asking questions such as, "Which suppliers are we going to recruit to electronic invoicing?"

Figure 5: Sample Spend Segmentation



J.P. Morgan's spend analysis includes the segmentation of spend into four basic categories: direct spend, spend with card-accepting suppliers, non-discountable spend and indirect spend. This last category of spend, from non-strategic suppliers, includes many suppliers with little access to capital and a real need for accelerated cash. Organizations are capturing a significant amount of discounts in this category.

⁵ 2004 Report to the Nation on Occupational Fraud and Abuse

Bear in mind that the majority of strategic suppliers or “direct spend” already have a contract or purchase order (PO). Studies show, however, that as much as 75% of pre-negotiated savings are never realized.⁶ We also know that certain categories of spend such as government agencies, utilities and insurance companies typically do not offer discounts. For these spend categories, the ability to leverage order-to-pay automation to consistently pay on time is invaluable.

Conversely, spend analysis often reveals that a large portion of spend is from non-strategic or indirect suppliers of goods and services. Many of these suppliers are small “mom and pop” shops with little access to capital. These suppliers represent a significant opportunity for capturing incremental discounts.

Another important consideration is assessing a supplier’s propensity to participate in discounting. Make sure you measure specific industry discount penetration rates and apply these benchmarks to your supplier and spend categories to forecast discount capture by category. Leading service providers can assist in this essential business practice.

Identifying suppliers that accept credit card payments is another important step in a thorough supplier and spend analysis initiative. Often overlooked are the many high-volume, low-dollar spend suppliers that are being paid by paper check today. As we discussed earlier, converting these suppliers to commercial cards for settlement expands your p-card program. In the process, you will extend your DPO, improve cash on hand and increase your card-related rebates.

Figure 6: Sample Discount Penetration Rates by Industry

Industry	Discount Penetration Rates			
	Supplier	Invoice	Spend	Rate
Real Estate Services	45%	28%	59%	.9%
Paper & Packaging	58%	73%	40%	1.1%
Lumber & Wood Products	34%	37%	34%	1.3%
Industrial Equipment & Supplies	53%	63%	33%	1.5%
Printing Services	36%	30%	31%	1.4%
Stone, Clay, Glass & Concrete	42%	39%	28%	1.3%
Advertising & Marketing	38%	47%	25%	.9%
Transportation Services	34%	16%	22%	1.6%
Chemical Products	36%	42%	22%	1.0%
Forestry Services	39%	22%	22%	2.5%
Analytical Products	35%	36%	20%	1.3%

J.P. Morgan conducts a discount-potential analysis using proprietary industry and supplier heuristics obtained from its network with hundreds of billions of dollars in spend processed. Comparing your results against these industry benchmarks allows you to refine your supplier and spend objectives.

Supplier Onboarding

You should not underestimate the importance of recruiting and onboarding suppliers. These steps are vital to any effective order-to-pay automation initiative.

Successful onboarding depends to a great extent on the quality of information that your suppliers receive. You must clearly articulate the substantial benefits to suppliers to maximize their participation. These benefits include improved visibility into invoice and payment status as well as better cash forecasting. Emphasize the power of dynamic discounting as a new way for suppliers to gain control of payment acceleration and reduce their DSO.

At J.P. Morgan, we see broad participation in dynamic discounting from all categories of suppliers—primarily, we believe, because suppliers want improved visibility into their invoice status and are willing to sign up for discount terms to get that visibility. In addition, for those suppliers with net terms, dynamic discounting represents an alternative source of needed cash.

Today’s leading service providers offer a supplier onboarding service that can augment your team and help you effectively recruit and onboard 80% or more of your targeted suppliers.

⁶ “Harnessing Payables to Capture a Second Wave of Procurement Savings,” Aberdeen Group

Benchmarking & Performance Measurement

“We can’t improve what we can’t measure.”⁷

To achieve procure-to-pay excellence, many organizations turn to spend analytics as a source of potential savings in the form of volume discounts and vendor consolidation. Though this can be effective, the opportunity seems to have reached a plateau. As companies look to cut costs and manage risk, it is important to expand the scope of benchmarking to payables activities and set the right objectives.

Within the procure-to-pay process, early payment discounts are delivering substantial new cost savings. Equally important, organizations are earning these discounts while maintaining control over cash use and DPO. To optimize this process means focusing on the right process and supplier management metrics within the accounts payable function.

Benchmarking

Benchmarking is the process of measuring an organization’s internal processes before identifying, understanding and adapting outstanding practices from other organizations considered best-in-class.

A common mistake in benchmarking is to limit benchmarking activity to your own industry. While benchmarking within your industry is important, you must also compare your performance against firms outside your peer group.

Transaction data generated by a business settlement network can be invaluable in benchmarking your potential process and working capital savings across a broad cross-section of organizations.⁸ Using this data, you can measure results against stated objectives and also compare against the network as a whole.

Take on-time payments as an example. According to business advisory firm The Hackett Group, an on-time payment benchmark in the 95th percentile

represents world-class results, while this is the median result for J.P. Morgan’s Order-to-Pay clients.⁹

J.P. Morgan benchmarks a set of predefined key performance indicators (KPIs) across three order-to-pay areas: process, supplier and working capital. These benchmarks help order-to-pay clients understand how they are performing against their own objectives as well as the network as a whole. (Please see examples below.)

Performance Measurement

Once you identify what to benchmark, set realistic targets over a fixed time period and then measure results against those stated objectives. In Figure 7 on page 9, we see a sample of an order-to-pay client’s cumulative results in green mapped against its three-year forecast in gold. These charts can show whether the client is on track toward its goal of automating payments and invoices, and maximizing discounts.

Examples of KPIs that J.P. Morgan benchmarks and measures for clients include:

PROCESS

- % of electronic and paper—% of invoices that are electronic
- On-time payment %—% of payments that are made on time
- Discount approval on-time %—% of invoices approved by the discount due date

SUPPLIER

- % enrolled—% of targeted suppliers enrolled
- % with discount term—% of suppliers that enroll with a discount term
- % dynamic discounting—% of suppliers that participate in dynamic discounting

WORKING CAPITAL

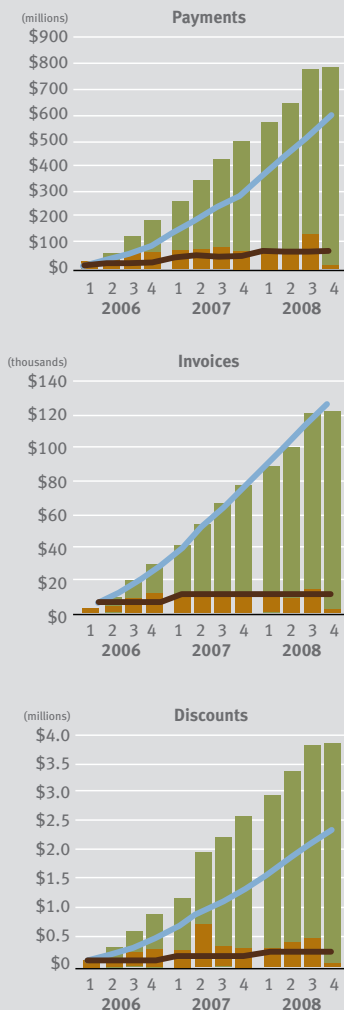
- DPO—average payable period
- Discount APR—the annualized rate of return on cash used to fund discount program
- Discount rate—the average discount rate
- Discount penetration—the % of suppliers, invoices and spend that is discounted

⁷ “Reengineering the Corporation,” Michael Hammer

⁸ With tens of thousands of trading partners, J.P. Morgan is able to benchmark results at an aggregate network level and provide a reasonable forecast of what clients can expect in terms of operational and working capital savings.

⁹ Based upon transaction data from J.P. Morgan’s Network Insight service

Figure 7: Forecasting and Measurement of Results



J.P. Morgan helps its Order-to-Pay clients measure results against their stated objectives.

In addition to tracking performance, having the right data can show you why you are doing well or performing poorly. As an example, if results in Figure 7 indicated that a client was falling short of its discount objectives, the client could measure its performance against network and industry benchmarks to understand which categories of spend were lagging.

Once any problems are isolated, you can make adjustments to your discount program, targeted suppliers or other areas. By regularly monitoring this process, you continue to improve performance and maximize your operational and working capital savings.

Conclusion

Automating accounts payable with an order-to-pay solution enables straight-through processing that unlocks working capital tied up in your payables process. By shifting from an “extend payables only” model to incorporate an “accelerate for discounts” approach, you can proactively leverage your payables balances to optimize working capital without negatively impacting your DPO.

The incentive for suppliers to offer discounts for prompt payment is the opportunity to accelerate their collections and reduce DSO. This can occur systematically through a standard discount term or on an ad hoc basis with dynamic discounting. For example, to help fund a capital project or meet end-of-quarter financial goals, a supplier might want to accelerate payment for a large order by offering a discount. Order-to-pay automation makes this possible, not only for large, strategic suppliers but for suppliers of any size or level of technical sophistication.

Recent surveys confirm that this cash management potential is latent in the marketplace.¹⁰ In economic terms, the net effect is that buyers are paying too much for their goods and services, and suppliers are not getting timely access to the cash they need. Clearly, this cash flow conundrum represents an opportunity to optimize working capital.

This opportunity goes far beyond the discounts you have in place. By leveraging a supplier network such as the J.P. Morgan Business Settlement Network, you can expand your reach and incorporate a larger segment of suppliers and spend into your discount programs. A financial services institution that offers complementary products and services—such as single-use commercial card accounts, supply chain financing and imaging services—can enhance the value of your working capital optimization effort. In the case of J.P. Morgan, flexible pricing options can’t be matched by providers relying on third-party partners. This presents other advantages: for example, expanding p-card settlement to accounts payable spend where the additional rebates can self-fund an order-to-pay automation initiative.

As an on-demand platform, J.P. Morgan’s Order-to-Pay service leverages and extends your existing enterprise resource planning (ERP) and accounting systems. You can start with e-payment or e-invoicing as a first step or proceed with a comprehensive order-to-pay automation strategy. With either approach, by combining accounts payable automation with benchmarking and performance measurement, you can optimize working capital with less risk and far greater results.

¹⁰ According to a J.P. Morgan survey of networked suppliers, 85% stated that they would always or occasionally accelerate payments for discounts. In discussions with more than 200 Fortune 2000 companies, however, J.P. Morgan found that only 5% of suppliers on average offer discount terms. In addition, according to the Aberdeen Group, 70% of negotiated discounts are never realized.

For more information about J.P. Morgan's Order-to-Pay service and our other electronic payment processing solutions, contact us at 877-944-6877 or visit us at jpmorgan.com/ordertopay.

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