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4 Ways to Avoid the Direct Procurement Trap

An Exploration of Direct Procurement Automation Technology

Q2 2015 | Featuring insights on...

- Unique Challenges in Direct Procurement and Sourcing
- Differences Between Direct and Indirect Procurement Management
- Benefits of Direct Procurement and Sourcing Technology

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Contents

Introduction

Today's organizations are increasing their focus on financial process automation, and many are moving to automate key Purchase-to-Pay activities like sourcing and procurement. Indirect goods management software providers are a major leader in this space, as they provide simple process and cost control for requisitioning and purchasing operations. However, the value of these solutions may be limited in industries where indirect spend is less than direct procurement spend, as direct procurement involves a far different set of requirements.

Directs goods procurement is a much more complex and expansive process than indirect procurement. It entails multinational suppliers, lengthy lead times, and heavy reliance on logistics. Direct procurement also requires extensive collaboration—there are numerous parties and activities in each order's lifecycle that procurement officers must track, coordinate, and control. Direct procurement has greater impact on organizations' customer retention, as failures in supply chain management and product delivery affect customer experience and loyalty, as well as business success and growth. Because of the high-risk factors at play in direct procurement, it is very important to get this process just right.

For companies with much higher demand for direct goods, indirect procurement automation does not provide the most complete and efficient management. Direct goods management solutions are designed to bring a more holistic approach to the supply chain, handling complex and lengthy order lifecycles and enabling strategic, collaborative procurement. This publication serves as a concise guide to the relevance and strategic uses of these solutions for today's organizations.

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Direct Procurement: The Inherent Challenges

As any procurement professional knows, the most obvious differences between indirect and direct procurement revolve around type of goods ordered, lead times, and supply chain complexity. Another great difference is between the inherent structures and process requirements of the two departments. While both direct and indirect procurement involve professionals with a close focus on commodity management, the reach of direct procurement professionals goes far beyond simply making sure a PO is fulfilled. These professionals must pay close attention to things like continuity of supply, materials for inbound manufacturing, demand volatility, and buffering demand—all of which can quickly and greatly affect PO lines, order quantities, and shipment times. Direct procurement involves much more time, attention, and collaboration between procurement specialists, buyer planners, supply chain managers, and suppliers to correctly and thoroughly complete the process.

Because of its special needs, direct procurement requires a software that is more involved and holistic than indirect procurement solutions. By automating direct procurement, a single platform can manage core dimensions and provide specialization beyond the indirect procurement process, enabling visibility and control of planning, logistics, and communication.

On the other hand, when organizations do not automate, they risk falling into the direct procurement trap: a persistent cycle of delays and inefficiencies that hurt a company's bottom line and future business success. The following sections outline four strategic initiatives organizations can deploy to address direct procurement challenges and avoid costly mistakes.

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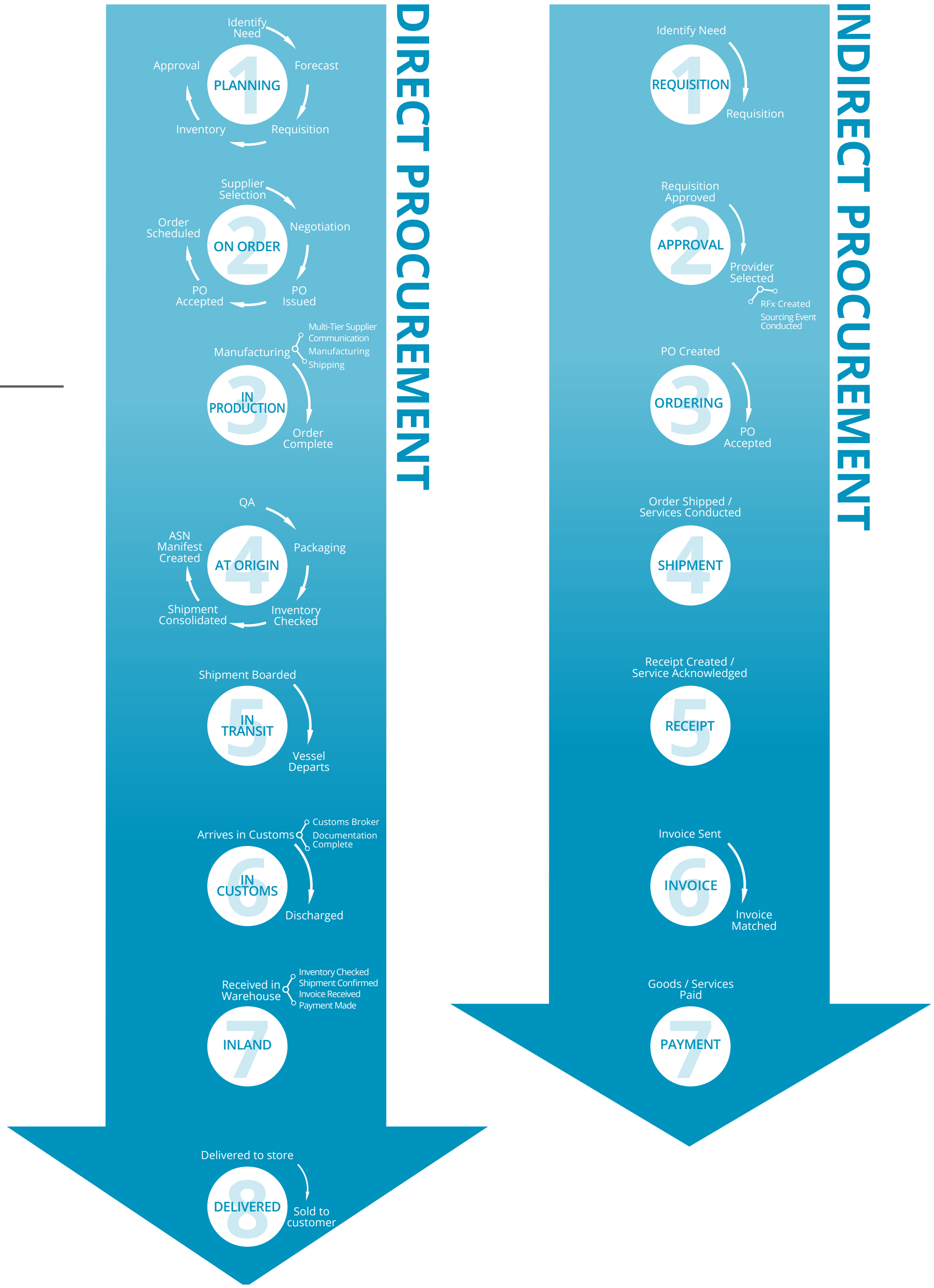
Figure 1

Direct vs. Indirect Procurement



<u>Direct Procurement Internal Parties:</u>

Merchandising/Inventory, Sourcing/Procurement, Vendor Compliance, Treasury, Accounts Payable, Supply Chain, Logistic, Buyer-planners, Warehouse

<u>Direct Procurement External Parties:</u>

Buyers, Suppliers, Factory, Broker, Consolidator, Freight Forwarder, Carrier, Agents, Local Offices, Banks/Third Party Financiers, Component Suppliers

<u>InDirect Procurement Internal Parties:</u>

Sourcing/Procurement, Approver (Treasury/ Finance, Inventory, C-Suite, etc.), Accounts Payable, Supplier Management, Warehouse

<u>InDirect Procurement External Parties:</u>

Supplier/Service Provider, Bank/Third Party Financier

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#1: Streamline Logistics

Indirect procurement is mainly focused on requisitioning the best products at the best price to keep costs low, as well as paying invoices early to ensure savings. In contrast, direct procurement necessitates careful and long-term financial planning for a successful supply chain. Logistics are only a small factor in the indirect procurement process, while in direct procurement they have a direct impact on customer experience and business success. Properly managing the extensive amount of data among many different parties ensures that the supplier is packing, producing, and shipping orders correctly, and that all goods are delivered in the most secure, efficient, and compliant way possible.

The more complex and widespread the supply chain, the more specifications that will be involved, as these orders involve things like multiple parties (co-signees, logistics providers, brokers), multiple destinations, HTS codes, and detailed specifications for what to produce, and how to pack and ship it. If an organization needs to finance its orders, it needs to know and communicate exactly what financing strategy it will take. If a shipment requires a specific kind of shipping container or vessel, the supplier will need to make sure this request is fulfilled. All these factors require more than one procurement manager checking in with suppliers—direct procurement necessitates extensive connectivity and collaboration between the various departments within the organization and multiple supply chain partners.

For example, a shipment manager could be working with a procurement professional on receiving products from the supplier. Together, they will have to consider how the goods should be packaged and labeled, the destination, the mode of transport, and when they should be shipped. This scenario goes beyond whether or not the supplier has approved a PO—it determines whether the supplier will ultimately be able to ship on time--in full (OTIF). For this collaboration to run smoothly, all parties must have shared visibility into the forecasting process, the target service levels, the procurement collaboration process flow, and all the shipment processes, from the factory to customs clearance and compliance. All these elements become the key considerations for both parties, making visibility into them very important to successful direct procurement.

Indirect procurement involves short lifecycles, short orders, and a minimum amount of associated information between invoices and POs. In contrast, a direct procurement order contains a considerable amount of information that varies in structure and complexity, and by the types of goods and manufacturing processes involved (example: discrete vs process manufacturing). Additionally, throughout the order's lengthy lifecycle there will be the sharing vital data between buyers, suppliers, and logistics, some of which takes the form of multiple order changes. Procurement officers need this data for legal and tax compliance, as well as to know and share their position with a number of parties, including both internal departments like inventory or treasury and external partners like banks or tax authorities. Buyers and planners need to be able to see the open forecast and open and committed POs, and they must have the ability to collaborate dynamically on rescheduling those POs. Finally, logistics and receiving must have this information to plan and track the goods being shipped. Visibility into inventory, POs, shipments, and payments is vital for ensuring strong supply chain activity and supplier relationships.

Another aspect of logistics to consider is transportation procurement. Given the global nature of supply often found in direct procurement, transportation planning is key in managing overall supply chain lead times and costs. Planning for how the goods move from the supplier involves the coordination of various modes of transportation, routes, and carriers. Even after a shipment has reached the buyer's home country, it must be tracked, as it can be sent to places other than the company's headquarters or warehouse—it may go directly to the stores or even to a third party for storage or distribution. Procurement professionals must arrange the right delivery vehicle for these goods to each location, and they must make sure all deliveries are made securely and on time. Transportation procurement has a great impact on the delivery of goods to customers, preventing goods shortages and maintaining a positive customer experience.

#2: Maintain a Global Reach

Globalization has played a large role in transforming the way that organizations manage their procurement and sourcing procedures. Global direct procurement goes beyond simply ordering a laptop for office work—businesses must manage an expansive and diverse supply chain that operates across many borders. Orders could originate from China but ship into Europe, and the efficient flow of goods requires more touch points among more parties to make sure data is reported accurately and updated in real time. Businesses often need different procurement strategies depending on different countries, as with each new region there are new legal and trade requirements. In addition, shipping orders across borders entails extensive documentation to clear customs, as well as detailed coordination between organizations, trading partners, and even local governments.

An indirect order is delivered directly to an organization's doorstep, but direct procurement entails delivering final goods to customers—a much more elaborate and time-sensitive journey. The complexities of direct procurement escalate across the number and geographical range of business partners, the type of transactions with these partners, and the different flows of both financial (e.g., methods of payments, financing) and physical assets (e.g., intermediary and final goods).

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#3: Establish a Collaborative Supply Chain Environment

The supplier base for direct procurement is usually much wider than that of indirect goods, and the process often entails slower lead times and more valuable goods at stake. For that reason, errors carry much more weight in direct procurement than indirect, and process inefficiencies can create huge setbacks in business operations, as well as great losses in revenue. Factors like supply chain movement, supplier base health, and brand value play a large part in direct procurement management.

The direct procurement process requires connecting directly with a preferred supplier to share forecasts and place orders. However, the process does not stop there, as direct procurement lifecycles often involve multi-tiered supply chains. Suppose a large retailer needs to produce a certain number of leather jackets to replenish inventory throughout its EU locations. The leather comes from Italy, the zipper and metal clasps from China, and the cotton thread from the US, all of which needs to be shipped to Mexico, where the jackets are manufactured, before the final product is shipped to a distributor in the EU. In this case, the production line includes multiple parties producing and delivering materials, and the lead time before the final delivery will be dependent on the efficiency each of these supply chain tiers.

The data on complex, direct-goods orders drives upstream transactions, making it important that the forecast is visible to organizations. Lead times can change quickly and dramatically due to a number of circumstances, and buyers' demands can also change, possibly requiring order updates. Because of the possibility of complications on each side of an order, direct visibility into all supply chain processes is vital in direct procurement.

In addition, direct goods orders generally consist of more strategic items and larger units than an order of indirect goods, and many times, the buyer will be required to pay their suppliers before they receive their shipment simply to keep production going. For this reason, organizations ordering direct goods must have access to Supply Chain Financing, as it provides them with third-party funding to provide their suppliers with access to capital as early as is strategically necessary. This maintains the health and efficiency of the supply chain and their supplier base.

#4: Automate Direct Procurement

Direct goods management, involves many risks for businesses, including for production activity, bottom-line costs, brand value, and customer service and loyalty. A company needs a direct sourcing and procurement solution that ensures that goods are delivered on time and in the right quantity.

Today, direct procurement technology enables organizations to holistically manage their direct goods order lifecycle, from financing the supply chain to final delivery. These solutions connect buying organizations with suppliers and deliver expected billable sales ahead of time. They bring visibility into factory activity and progress, providing more accurate and detailed lead-time estimations. They allow organizations to manage multi-tired supply chains with multiple-level ordering functionality and coordination tools. They facilitate overseas shipment, combine shipments, and track shipping activity. They can set up multiple destinations for intermediary or final delivery, whether the order is going to a factory, warehouse, or retail location. They help with clearing customs and dealing with customs brokers. They streamline the receipt of many invoice types, and they include multi-language, currency, and tax support.

When organizations are looking into direct sourcing and procurement technologies, they should explore solutions that enable them to:

Connect the Right Parties:

There are many different forms of financial automation technology. Cloud-based software is especially useful for direct procurement management, as it opens up the possibilities for data sharing and logistics with multiple parties. However, while there are definite cost benefits of cloud technology for organizations, not all of it is created equal. There are private and public cloud systems, each with its virtues, but in a public, well-secured multi-tenant and multi-enterprise cloud system, organizations are given a special differentiation in value. All users come to one place to have access to the same clean data—data that maintains its accuracy, value, and integrity as it moves.

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Engage Communities:

Organizations have a few different internal departments and systems associated with indirect goods orders, such as the ERP & WMS, but these parties are different from those needed for direct goods engagement. Direct sourcing and procurement may involve banks, customs brokers, freight forwarders, consolidators, ocean carriers, suppliers, factories, raw materials providers, and more, and organizations need the right technology to facilitate the coordination between these parties.

The solution must also enable the many different procurement strategies that companies may use. For example, if an organization is issuing an order directly to a supplier in a new country, they may use an agent to ensure that this process is done correctly. The buyer will need a tool for getting relevant information to the agent and, in turn, for the agent to use in communication and operations with the supplier.

Integrate the Physical and Financial Supply Chain:

Having a supply chain transaction integrated with the flow of the money is critical for successful direct procurement, as each is dependent on and triggers the other. Capital is needed at various points in the supply chain process to keep things moving. For example, a supplier may request financing on a PO to access capital needed to produce the goods, and automation and visibility into fulfillment documents can affect the time scale on an invoice payment. Having an integrated process is very important for a timely order lifecycle, and advanced procurement solutions will enable smooth and streamlined interaction.

Strategic vs. Tactical Procurement

In today's software market, many procurement technology providers will claim they have a hold on both indirect and direct material procurement. However, in most cases, their solutions' functionality ends at the point of sourcing, only really managing tactical procurement. True strategic procurement extends much further than this, as it follows a PO throughout its entire complex and sensitive lifecycle.

With direct-materials management, the PO is linked with the supply chain functions, including inventory, shipments, and more. The PO is much more reflective of supplier activities, as it integrates supplier scorecard tools and performance management. In all, strategic direct procurement systems require a broad extension of the management of the PO lifecycle far beyond PO to invoice automation.

With indirect procurement, the process revolves around commodified items—issuing bids or requisitions in order to find the lowest bidder or least expensive product. With a direct project, procurement must carefully manage the entire order lifecycle process, with all supplier activity, communication, and order movement aligned, and with everything falling under the same focus of control and execution. The differentiation between indirect and direct procurement is really the difference between tactical and strategic procurement.

Instead of simply capturing savings through competitive prices, procurement mangers must essentially carve out their savings with careful and dynamic supply chain management. They must closely watch supply chain costs and carefully monitor logistics choices, such as selecting a type of machinery that will be most productive and cost-efficient. When this process is executed successfully, organizations can protect their margins and drive their production forward. While indirect procurement management is simply the search for lowest costs, direct procurement creates business growth, and the most vital areas of a business functions are dependent on its success.

In addition, there are many other systems in an enterprise that must be integrated with the direct procurement process. These could include forecasting on planning systems, logistics systems, materials system, and treasury systems—much more than the simple ERP and inventory integration involved in an indirect system. For that reason, direct procurement software must be viewed as a vital foudnation upon which many other business strategies depend.

In all, direct and indirect procurement needs depend on the size, industry, and location of an organization, among other factors. However, while these solutions are not one-size-fits-all, the underlying distinction of tactical versus strategic procurement and their associated Purchase-to Pay-requirements is very important to consider. Acknowledging this distinction can impact the success of a company, and ignoring it can rob businesses of their market foothold and hurt their bottom line.

About PayStream Advisors

PayStream Advisors is a technology research and consulting firm that improves the way companies plan, evaluate, and select emerging technologies to achieve their business objectives. PayStream Advisors assists clients in sorting through the growing complexities of IT applications related to business process automation with the goal of making objective, analytical, and actionable recommendations. Wherever business process automation technology is an issue, PayStream Advisors is there to help. For more information, call (704) 523-7357 or visit us on the web at www.paystreamadvisors.com.