The Study of Financial Supply Chain Management : Challenges and Obstacles

Dr. Brijesh Kumar Agarwal
Associate Professor, Faculty of Commerce and Business Administration, D. N. College, Meerut (UP)

Abstract

Supply Chain Financing (SCF) is a product offered by banking sector to realize lower prices for credits. This product is offered to the supplier on the basis of the creditworthiness of the buyer. Credits can therefore been offered at a lower rate of financing than the supplier would be able to negotiate on its own. The goal of working capital management is to keep working capital on an optimal level. This optimal level is the level needed in order to meet the obligations of the company without having excessive levels of cash. Working capital management is concerned with the cash flows moving around the company and it is a big advantage if a company has a clear picture of where funds are required. The present study is a distinct type of work based on secondary information. This is a descriptive work. It discusses various challenges and obstacles which may come in the way of financial supply chain management. Companies can use the financial crisis as an opportunity to rethink their business model. This requires also further development of research in the area of short term financial management and tools for a more accurate risk management.

Keywords : *Financial Supply Chain Management, Working Capital Management, Purchase to Pay cycle, Order to Cash Cycle, Days Payables Outstanding.*

JEL Classification : *G 31, G 32.*

1. INTRODUCTION

Supply Chain Financing (SCF) is a product offered by banking sector to realize lower prices for credits. This product is offered to the supplier on the basis of the creditworthiness of the buyer. Credits can therefore been offered at a lower rate of financing than the supplier would be able to negotiate on its own. The Aberdeen Group defines Supply Chain Financing as: "A combination of trade financing provided by a financial institution, a third-party vendor, or a corporation itself and a technology platform that unites trading partners and financial institutions electronically and provides the financing triggers based on the occurrence of one or several supply chain events. Effective supply chain management requires a different approach to doing business than many companies have had in the past. In particular, collaboration and transfer of information between different departments managing each element of the supply chain is a key. A holistic approach to liquidity management may enhance process

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efficiency due to the use of electronic invoices and electronic payment. Finance divisions need to be more innovative in the ways they raise finance and manage liquidity. Eventually, the goal is to obtain visibility over the purchase-to-order and order-to-cash processes. This can lead to efficiencies and cost savings throughout the chain. The better the parties know how and where the cash flows throughout the chain (in other words, better visibility), the better companies may optimize these flows and may need less working capital resulting in less credits to be obtained from banks. This will lead to cost savings for all parties and consequently, to more investment opportunities.

Companies generally focus on their supply chains when they are interested in the following issues:

- Obtaining visibility over all the processes involved in the financial supply chain.
- Increasing efficiencies throughout the chain.
- Reducing costs throughout the chain.
- Freeing up working capital by obtaining a clearer picture of where funds are required.
- Adopting a collaborative approach towards other parties in the chain.

2. WORKING CAPITAL MANAGEMENT

Working capital means the difference between short-term assets and short-term liabilities. Cronie gives the following definition of working capital: "the amount of cash which a company requires to fund the difference between payment and collection".

Thus, working capital management means the management of current assets and the entire current liabilities, as also a portion of long-term or deferred liabilities, which go to meet the financial requirements of working capital.

The goal of working capital management is to keep working capital on an optimal level. This optimal level is the level needed in order to meet the obligations of the company without having excessive levels of cash. Working capital management is concerned with the cash flows moving around the company and it is a big advantage if a company has a clear picture of where funds are required. Nevertheless, it is important to know that working capital levels differ between industries. Working capital would not exist if every product sold was distributed on the same days as the invoice was raised and paid.

The amount of necessary working capital depends on several factors. According to Mathur (2002) the amount of working capital a company requires largely depends on:

- Nature of business (e.g. automobiles)
- Seasonal character of industry (e.g. fans)
- Production policy (e.g. varying with peak and slack season)
- Market conditions (e.g. competition)
- Supply condition (e.g. materials)

However, working capital management is not only concerned with payables and receivables. Inventory management and cash management are important aspects as well. The longer inventory is held, the longer cash is tied up and will not be directly available for the company.

According to Cronie (2008), good working capital management is providing the following benefits: "reducing the working capital requirement enhances the balance sheet and reduces the need for short term borrowing. Furthermore, it improves financial ratios and therefore increasing the ability to obtain financing for more strategic purposes ".

According to Bhattacharya (2008) a limitation concerning working capital management is the "correctness of assets and liabilities that enter into the domain of working capital management". If some assets are not as current as the liabilities used in the working capital management, it can lead to difficulties to make proper decisions.

3. RESEARCH METHODOLOGY OF THE STUDY

The present study is a distinct type of work based on secondary information. This is a descriptive work. It discusses various challenges and obstacles which may come in the way of financial supply chain management.

Objective : To study the challenges and obstacles of financial supply chain management.

4. CHALLENGES AND OBSTACLES OF FINANCIAL SUPPLY CHAIN MANAGEMENT

An optimised financial supply chain requires efficient internal processes, effective collaboration with financial partners, the right liquidity structures and the use of appropriate financing techniques. Many factors are also important for an optimized Financial Supply Chain. If one of the factors is lacking, the Financial Supply Chain may not be as optimized as it could be. Stephenson and Hutter (2009) add factor that is important in order to optimize the Financial Supply Chain: “there is a need to implement technology, for instance to ensure that files of approved payments can be routed from buyer to bank and from bank to suppliers”.

Furthermore, different departments are holding responsibilities (e.g. treasury, trade finance, accounts payable and accounts receivable) that are all elements of the Financial Supply Chain. These different responsibilities among departments make it difficult for a Financial Supply Chain to function smoothly. Each department has its own objectives and performance measurements which can be different from the overall Financial Supply Chain objectives and performance measurements.

The maturity period of an item can be different from company to company. In case of both current liabilities and current assets, there may be firms where maturity period of any of the items may be more than a year. If, therefore, we follow the logic of 'natural business year', then the true operating cycle of a business should be either the days of current assets or current liabilities whichever is higher. Only in such an operating cycle all current items will mature.

Unreliable and unpredictable cash flows, costly processes, high DSO and suboptimal credit decisions require higher working capital than are some challenges which required. If these challenges were removed, the cash saved could be shifted to more valuable users.

Wohlgeschaffen (2010) describes in his article the challenges of implementing a SCF package: “It was a challenge to make sure that the system was able to deal with credit notes and different currencies as well as individual limits for each supplier in order to mitigate or reduce risk to the buyer”.

5. PURCHASE-TO-PAY CYCLE

The purchase-to-pay cycle deals with the payables of a company. Purchase to pay cycle is the trade cycle from the point of view of the company making a purchase. During the purchase-to-pay cycle, the company selects, receives and pays for the materials or other inputs needed in order for it to produce its goods or services. To measure the average number of days taken by a company to pay its creditors in a given period, the Days Payables Outstanding (DPO) formula can be used. In case of cash payment directly, a company has to take opportunity costs into account.

According to Van Sten & Knapen (2009), “An opportunity cost is one that measures the opportunity that is lost or sacrificed when the choice of one course of action requires that an alternative course of action be given up” If a company holds too many products in its warehouse, it will have high storage costs. Besides, if a company has a shortage of goods, it may face lost sales.

Cronie (2008) agrees with this criticism by stating: “In addition to processing, managing payments is also a strategic element of working capital to ensure that the company is able to take advantage of early payment discounts offered by suppliers where these are beneficial.”

Both authors focus on the early payment discount that companies forgo in case of late payment.

6. ORDER-TO-CASH CYCLE

Accounts receivables are created by a firm when it sells its outputs on credit. The order-to-cash cycle relates to a company's receivables. The order-to-cash cycle is the same cycle as the purchase-to-pay cycle, however, from a supplier's perspective. It begins when a quote is prepared for a customer and ends when payment has been received and reconciled with the appropriate invoice.

To measure the average number of days taken by a company to collect payment from completed sale in a given period, the Days Sales Outstanding (DSO) formula can be used. The lower the DSO, the faster payment is collected and the sooner cash can be used for other purposes.

According to Cronie (2008), “prioritising collections is more valuable than payments, because benefits are more tangible and receivables are sometimes the largest or second largest asset on SME's balance sheets.”

A criticism concerning accounts receivables is that selling on credit is more expensive than cash sales. It involves more paperwork, more control and the risk involved is. A company usually does not know beforehand which receivables will become uncollectible. Accounts receivable are shown in the balance sheet at the estimated collectible amount, the net realisable value. An account receivable that has been determined uncollectible is no longer an asset. So, receivables need to be shown at net value.

7. CONCLUSION

Effective supply chain management requires a different approach to do business than many companies have had in the past. In particular, collaboration and transfer of information between different departments managing each element of the supply chain is a key. A holistic approach to liquidity management may enhance process efficiency due to the use of electronic invoices and electronic payment. Finance divisions need to be more innovative in the ways they raise finance and manage liquidity. By implementing electronic data transfer, companies can increase their competitiveness, freeing up working capital and reducing risk. Companies which ensure that their internal processes are aligned with the new opportunities are likely to derive the greatest benefits.

An optimized financial supply chain requires efficient internal processes, effective collaboration with financial partners, the right liquidity structures and the use of appropriate financing techniques. The financial flow management challenges such as slow processing, unreliable and unpredictable cash flows, costly processes, high DSO and suboptimal credit decisions require higher working capital than needed. If these challenges were removed, the cash saved could be shifted to more valuable users. Since the financial crisis financial markets are failing with increasing number of distortions. Companies can use the financial crisis as an opportunity to rethink their business model. This requires also further development of research in the area of short term financial management and tools for a more accurate risk management.

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