

## How to Better Manage Your Financial Supply Chain

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### Executive Summary

- Financial supply chain management (FSCM) addresses a number of initiatives that can help to make finance organizations more efficient and improve the working capital position of an enterprise.
- There are a number of indicators for an inefficient financial supply chain including low straight through processing rates and a high amount of uncollectible receivables on the balance sheet.
- Key performance indicators such as days sales outstanding or days in receivables can be used by companies to benchmark themselves with their peers.
- Microsoft decided to improve its financial supply chain to better utilize working capital, to reduce bank fees, to process payments more effectively and to gain better control of cash flows.

### Introduction

Benchmarks of business performance indicate that enterprise resource planning (ERP) systems and other enterprise technologies have transformed customer and supply chain processes but that the performance of the finance function has hardly changed. Although some companies have managed to improve the performance of their financial processes profoundly, financial functions are still neglected in many businesses, and days sales outstanding (DSO) and working capital needs are very high in several industries. The working capital scorecard for 2011 from *CFO Magazine* demonstrates that there are significant differences between high and low performers within an industry. In the pharmaceuticals industry, for example, the best score in DSO was 4448, while the worst score was 117—two times more than the sector median of 57. Research from the Hackett Group indicates that finance department costs continue to consume more than 1% of revenues in many companies, and CFOs struggle with poor transparency of their daily cash flows.

In times when unprecedented economic uncertainty and soaring stockholder expectations are putting every function under closer scrutiny than ever before, the finance function should be driving business, not holding it back. Financial supply chain management (FSCM) can help companies to remove some of the inefficiencies in operational processes in order to become more effective.

### Definitions of Financial Supply Chain Management

There are different definitions of the term *financial supply chain*, which appeared for the first time in 2000 and 2001. According to the research company Killen & Associates (2001), the financial supply chain “parallels the physical or materials supply chain and represents all transaction activities related to the flow of cash from the customer’s initial order through reconciliation and payment to the seller.” The Aberdeen Group, another research company, calls the financial supply chain “a range of B-to-B trade-related intra- and inter-company financial transaction-based functions and processes [which] begin before buyers and suppliers establish contact and proceed beyond the settlement process.” The two definitions emphasize different topics. Killen’s focuses on the parallelism between the physical and the financial supply chain, and it stresses a section of the cash flow cycle that I’ll discuss in more detail below. The Aberdeen Group’s definition focuses on the collaborative nature of financial supply chain management and reveals that the financial value chain isn’t limited to the inner walls of a company but includes communication and cooperation with business partners.

Both definitions focus on a process-oriented view of the financial supply chain that is basically correct; however, in many respects the explanations do not go far enough:

- They focus very much on the collaboration between companies—specifically, suppliers and customers—and they do not consider other important business partners within the financial supply chain, such as banks.
- They describe primarily the status quo, and do not stress the various dimensions for the optimization of business processes within the financial supply chain.

- The motivation, as well as the key performance indicators, for an efficient financial supply chain are not obvious.

Another definition that includes these three aspects is the following: Financial supply chain management (FSCM) is the holistic and comprehensive planning and controlling of all financial processes which are relevant within a company and for communication with other enterprises. The goal of FSCM is to increase the transparency and the level of automation of business processes along the financial value chain. The purpose is to save processing costs and reduce the working capital of the company. This definition doesn't consider where the financial supply chain actually begins and ends, because there are also analytical processes that are not directly related to a business process but which belong nonetheless to the financial supply chain. Let's now have a closer look at the indicators of an *inefficient* financial supply chain.

## Indicators of an Inefficient Financial Supply Chain

As we have seen, the financial supply chain is different from the physical supply chain because it deals with the flow of cash instead of goods. Just as in the physical supply chain, though, every day that's lost in the cash-to-cash cycle equals lost revenue. But how do you know that your financial value chain isn't working properly? Besides a number of rather operational problems, there are also several concrete key performance indicators and metrics that you can use to analyze your financial supply chain. You are most likely aware of the fact that the financial supply chain stretches across many different business processes. These are, in a broader sense, the two processes *order-to-cash* and *purchase-to-pay*, which consist of various sub-processes that are relevant to the financial aspects of the value chain.

The order-to-cash process includes, from the perspective of a supplier (or creditor), the following business process steps:

1. Creditworthiness check.
2. Invoice creation.
3. Cash forecast.
4. Financing of working capital.
5. Processing of dispute cases.
6. Cash collection.
7. Settlement and payment.
8. Account reconciliation.

From the perspective of a customer (or debtor), the purchase-to-pay process consists of the following business processes:

1. Procurement.
2. Cash forecast.
3. Financing of working capital.
4. Receipt of invoices.
5. Resolution of discrepancies or exceptions.
6. Invoice approval.
7. Settlement and payment.
8. Account reconciliation.

There are a number of operational factors within the order-to-cash and purchase-to-pay processes that can serve as indicators of a suboptimal financial supply chain. Some examples are:

- The number of paper-based business processes is very high and there are several changes in medium (for example, the creation of invoices).
- The straight-through processing rate is low, which means that there are multiple manual interventions and process steps.
- Companies struggle with a large number of dispute cases during the creation of invoices, and it takes them a lot of time to process these.
- There is a large amount of uncollectable receivables on the balance sheet, and many employees in receivables or collections management are involved in the resolution process.
- Enterprises haven't implemented a consistent credit management policy, which results in a number of bad debt losses.

- Management has difficulties in predicting cash flows.
- There is no centralized cash management to control payment streams, and the company maintains too many bank connections.

## Key Performance Indicators

There are various key performance indicators that are relevant for measurement in financial supply chain management. One key metric is the cash flow cycle, which defines the period from delivery by suppliers until the cash collection of receivables from customers (Figure 1). It is the time period required for the company to receive the invested funds back in the form of cash. The cash flow cycle can be divided into the *operating cycle*—which is the time period between delivery by suppliers and the actual cash collection of receivables, and the *cash flow cycle*—which is the time period between the cash payment for inventory and the cash collection of receivables. The longer the cash flow cycle, the greater is the working capital requirement of a company, which means that a reduction of the cash flow cycle will immediately free up liquidity.

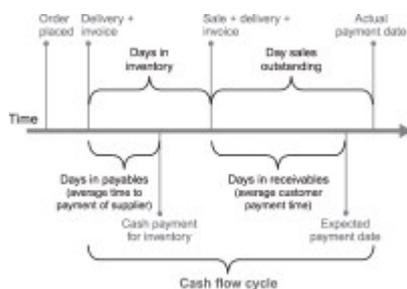


Figure 1. The cash flow cycle

Within the cash flow cycle we can differentiate the following parameters, which are delimited in Figure 1 with curly brackets:

- **Days in inventory:** This is the length of time between the delivery of the goods and the invoice from the supplier, and the sale of the goods and the invoice to the customer. It describes the average number of days the goods of a company remain in inventory before being sold. This metric is the focus for all activities around classical supply chain management.
- **Days in payables:** This is the length of time between delivery of the goods and the invoice from the supplier, and the actual payment for the inventory. This figure describes the average time it takes to pay a supplier. The parameter considers the outstanding receivables of a company, and is an important metric for debtors concentrating on their efforts to optimize the purchase-to-pay cycle.
- **Days sales outstanding:** This is the length of time between the sale of the goods and the invoice to the customer, and the actual payment date of the customer. This metric measures the average number of days companies need to collect revenue after a sale has been made. A high DSO number means that an enterprise is selling to its customers on credit and taking longer to collect money. The figure is an important figure for creditors, to optimize the order-to-cash cycle.
- **Days in receivables:** This is the length of time between the sale of the goods and the invoice to the customer, and the expected payment date. This key performance indicator is similar to DSO, and indicates the average time, in days, that receivables are outstanding. Days in receivables can also be called best possible DSO, since the company would collect all receivables before the due date.

Within the cash flow cycle there is potential to reduce both days in inventory and days sales outstanding. Days in payables can be reduced but should be monitored carefully to avoid putting supplies at risk. Days in receivables can be reduced by optimizing cash collection. Another important indicator for an efficient financial supply chain management is working capital, which is a balance sheet metric and part of the liquid assets. Working capital is calculated as current assets less current liabilities, and is a measure of the liquid reserve and short-term solvency of an enterprise, available to satisfy contingencies and uncertainties. One of the key objectives of financial supply chain management is to optimize the working capital by reducing, for instance, outstanding receivables.

## Case Study

### Microsoft

US company Microsoft decided to improve its financial supply chain by replacing third-party and in-house developed legacy software systems that were very costly to maintain. Microsoft, which is headquartered in Redmond, Washington, provides information technology, operating systems, middleware solutions, small/mid-size business applications, professional services, and other software solutions. The company reported annual sales in 2008 of more than US\$60 billion and had more than 90,000 employees worldwide.

The main business drivers for the company were:

- Better data integration between applications.
- Elimination of manual intercompany processes and month-end bank account reconciliation.
- More transparent accessibility to real-time data such as bank account balances, financial transactions, and accounts receivable and payable.
- More efficient usage of excess funds and better working capital management.
- Increased straight-through processing of foreign exchange trading.
- Reduction of bank fees and more cost-effective processing of payments.
- Risk reduction and better control of cash flows.
- Better utilization of human resources.

Microsoft decided to implement a vendor's financial supply chain management solution to complement its existing enterprise resource planning (ERP) landscape. The company realized a number of benefits from the project and was, for example, able to automate the confirmation process in the foreign exchange settlement fully. Exception rates are now smaller than 5%, the settlement process went from four hours to less than 15 minutes, and the percentage of settlement errors is approaching 0%.

## More Info

### Books:

- Bhalla, V. K. *Working Capital Management: Text and Cases*. New Delhi: Anmol Publications, 2006.
- Horcher, Karen A. *Essentials of Managing Treasury*. Hoboken, NJ: Wiley, 2006.
- Nash, Thomas. *Financial Supply Chain Management: The Next Wave*. Farnham, UK: Gower, 2012.
- Sagner, James. *Essentials of Working Capital Management*. Hoboken, NJ: Wiley, 2010.
- Salek, John G. *Accounts Receivable Management Best Practices*. Hoboken, NJ: Wiley, 2005.
- Schaeffer, Mary S. *Essentials of Credit, Collections, and Accounts Receivable*. Hoboken, NJ: Wiley, 2002.

### Articles:

- Hartley-Urquhart, Roland. "Managing the financial supply chain." *Supply Chain Management Review* (2006). Online at: [www.scmr.com/article/CA6376439.html](http://www.scmr.com/article/CA6376439.html)
- Katz, David M. "Easing the Squeeze: The 2011 working capital scorecard." *CFO Europe Magazine* (July/August 2011). Online at: [www.cfo.com/article.cfm/14586631](http://www.cfo.com/article.cfm/14586631)

### Websites:

- CFO—News and insight for financial executives: [www.cfo.com](http://www.cfo.com)
- gtnews—Library for finance and treasury professionals: [www.gtnews.com](http://www.gtnews.com)
- The Hackett Group: [www.thehackettgroup.com](http://www.thehackettgroup.com)

## See Also

### Best Practice

- [Best-Practice Working Capital Management: Techniques for Optimizing Inventories, Receivables, and Payables](#)

- [Factoring and Invoice Discounting: Working Capital Management Options](#)
- [Payment Factories: How to Streamline Financial Flows](#)

#### Checklists

- [Building an Efficient Credit and Collection Accounts System](#)
- [Choosing the Right Payment Policy](#)
- [Key Components of an Optimal Enterprise Resource Planning System](#)
- [Understanding and Using the Cash Conversion Cycle](#)
- [Understanding Key Performance Indicators](#)

#### Finance Library

- [Cashflow Reengineering: How to Optimize the Cashflow Timeline and Improve Financial Efficiency](#)

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Find unique solutions to enhance your supply chain strategy and logistics. From implementing blockchain and IoT technologies to the integration of green practices into your supply chain management, stay on top of all tendencies in the industry for 2020. How to Reshape Your Supply Chain Strategy in 2020. #Article. #Blockchain. What is your supply chain strategy, and how does it support your business strategy? For which customers, products, and segments does your supply chain target the best performance? Where does it optimize for cost rather than for service? Do you have clear supply chain performance and cost targets? Which KPIs do you use to measure these? How quickly can you ramp up production of a new product or a new sales region? Is your supply chain agile enough to flexibly respond to external changes? Three examples illustrate the difference supply-chain excellence can make. One leading company in consumer packaged goods uses its supply chain to manage input-price volatility. It has created multiple recipes and supply chains for a core brand of cleaning products. How do you define supply chain management? Many people use the term "supply chain management" when they are really talking about the procurement, logistics, or operations functions. To be effective in improving your company's supply chain, you need to have a broader perspective. For example, a project that reduces procurement costs can end up increasing costs for logistics and operations. Supply chain management should be viewed as the process of synchronizing the activities within your company and aligning them with your customers and suppliers. What information do you share with suppliers? Although sharing non-financial data with other companies for benchmarking studies is usually perfectly legal, it's illegal to share some information that could stifle competition. Supply chain management involves implementing the cross-functional relationships with suppliers and key customers in the network. The best companies, critically, continue evolving and reinventing their supply chains, regardless of their position in the market. In this way, these companies manage risks better, respond to any change in the technological, economic, and competitive environment, and exploit fresh opportunities far more efficient way than their peers. Most of them fail to set up a link between financial information and the logistics process and miss out on revenue. We have identified the following actions that the top management can adopt for maximizing the supply chain system's potential of their company. 1. Inventory management.