Integrating the financial supply chain for Supply Chain Finance

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Early payment discount programmes and Supply Chain Finance are offered to support key suppliers in a supply chain, and to take advantage of discounts offered by suppliers. However, these programmes are difficult to operate without the correct information and tools. Integrating the links in the financial supply chain can open up working capital optimisation possibilities that are not otherwise possible.

Pre-requisites for early payment programmes

The primary pre-requisite for a successful early payment transaction is a suitable payment window – in other words, that a supplier invoice can be approved early enough in the payment cycle to provide substantial value to the supplier.

Other pre-requisites include a source of funding that is available to the supplier at a suitable cost of funds, which can either come from the buyer's working capital, treasury resources or external funding partners; and an efficient flow of information between buyer, supplier and funder that allows for timely submission and approval of invoices, and low-risk funding and control.

These may not present any major issues in industries, companies or geographies where 90 to 120 days payment terms are common. However, in the more common case it is unlikely that (for example) a government agency that aims to comply with EU prompt payment legislation will be able to offer early payment if it receives and scans paper invoices into a manual approval workflow.

To support early payment discount programmes, many organisations need to upgrade their procurement and AP processes, to move from a 'just-in-time' invoice approval process, to automated receipt, matching, approval and payment.

The traditional financial supply chain

The financial supply chain extends from new product development and procurement right through to invoicing, payment and after-sales. Many opportunities exist along the chain to provide business and financial services to all transacting parties, and many of these have been filled by traditional financial services such as Letters of Credit, Trade Insurance and Invoice Discounting.

Without linkages in the chain, these products operate in a high-risk, fast-moving environment. For instance, Invoice Discounting is expensive because the funder has very little visibility of the buyer's actual commitment. It is generally not possible to enter into a one-off agreement because commercial transactions happen within recurring transaction streams; as a result, most financial transactions happen as part of parallel financial framework agreements.

Transacting partners do not readily have visibility of information that other partners hold – for example, credit risk assessments, invoice approval statuses, payment schedules. Sharing this information can greatly speed up cycle times and reduce trading risks.

Two common causes of Supply Chain Finance programme failure are:

- Slow turn-around times for invoice approval
  Delays are caused in invoice transmission; scanning and data capture; and getting appropriate approvals from line management and senior management

- Quality of the data available to the funder
  Information gaps in the Invoice-to-Pay process and in payment reconciliation can lead to premature payment, duplicate payments and missed payments.

How the integrated Financial Supply Chain helps

Integrating part or all of the supply chain allows sharing of information and data, both between the transacting parties in the chain, and within each party's organisation. Counterparty risk is reduced; automated transaction processing speeds up turnaround times; and one-off agreements can be executed quickly in the correct context.

Sharing key information on the end-to-end process provides closed-loop control and reconciliation and removes the risk of payment errors.

For early payment of invoices – using either internal or external funds - timely approval of invoices is essential. This assumes a level of integration between procurement, invoicing, payment and reconciliation processes and systems, and with current best practice, over 90% of all invoices can be approved and available for payment within minutes of submission.

Three early payment configurations are available:

- Early payment using the buyer's working capital
- Early payment using the buyer's treasury resources
- Early payment using external funds.

Early payment may be mandated by the buyer, or may be selected as an option by the supplier.

Typical opportunities for integration include:

- Electronic invoicing and supplier portals, linking suppliers to buyers
- Purchase management, AP Automation and workflow solutions, linking the buyer's procurement, AP, line management and payment functions
- Supply Chain Finance platforms, linking the buyer's payment function with internal or external funders.

Opportunities exist to save both on procurement spending and on operational costs, with no adverse impact on the buyer's balance sheet or the supply chain.

Funding early payment discount programmes

In an organisation that has a proven capability to approve invoices early in the payment cycle, there is a significant opportunity to cut input costs through an early payment discount programme. Strategically, the issue becomes how that organisation supports the funding requirements for the programme. There are two primary sources of funds – internal and external. This is where early payment discount programmes and supply chain finance diverge, as SCF typically involves external funding sources to pay suppliers, based on the collaboration and credit rating of the buyer.

The most intuitive option is for a buyer to pay its purchase invoices early, in return for a discount, using its own working capital. This discharges Accounts Payable liabilities but also reduces available working capital. However, the programme has no external visibility, and the entire early payment discount goes to the buyer's bottom-line.

Alternatively, the buyer may use its treasury reserves or cash surpluses from non-working capital sources to fund an early payment discount programme. In this case, information and tools are needed to coordinate the interactions between Accounts Payable, who will manage the approval process, and treasury operations, who will make decisions on the availability and the cost of funds.

Both of these options require the buyer to set aside a pool of funds to support the programme, and this could be between 10-20% of total procurement spending. Both options also involve a trade-off between free cash flow and net income – taking an early payment discount increases operating margin, but reduces available working capital.

A buyer may not be in a position to fund internally; or may decide for strategic reasons to conserve its own cash reserves and to open up the programme to external funders. In this case, there is no impact on the buyer's working capital position or on the balance sheet. However, while it may share in the discount to some extent, the buyer will not benefit to the full amount of the supplier discount. Because of this, one of the primary motivations for supply chain finance using external funds is to ensure that a supply chain is supported financially, and to reduce the risk of the failure of a key supplier. In addition, the buyer has the opportunity to maintain or even extend their standard payment terms without affecting the financial stability of the supply chain.

Differing models of Supply Chain Finance

Two variants of Supply Chain Finance are emerging, which while both offering the same basic premise – early payment of supplier invoices, using external funds, based on sharing approval information between buyer and funder – have substantially different implementations.

- A bank-centric model of supply chain finance involves a single bank and a technology/service provider; a set of buyers who are clients of the bank; and a network of their suppliers who may or may not be clients of that bank.

- A buyer-centric model involves one or more buyers, their suppliers, a service provider and one or more funders who offer financing to those suppliers based on intelligence from the buyer.

In either case, information is shared between the buyers and the funders which greatly reduces the risk of early payment to any supplier. Some buyers will favour the buyer-centric model as it provides bank independence and greater competition in the funding pool. Others may opt for the bank-centric model as a strengthening of their relationship with a primary banking partner.

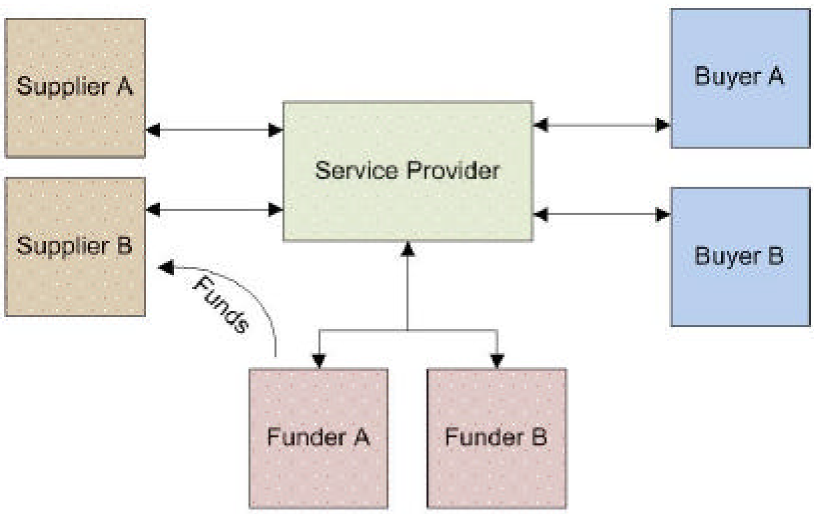

Figure 1: Buyer-centric SCF model

The end-to-end integrated financial supply chain

An integrated financial supply chain model provides the means for collaboration between:

- Suppliers' Accounts Receivable and buyers' Accounts Payable - so that invoices can be electronically transmitted and received with no manual intervention
- Procurement and Accounts Payable – so that invoices can be automatically matched against orders and receipts
- Accounts Payable and ERP systems – so that invoices are automatically and correctly processed, coded and accounted for
- Accounts Payable and funding sources, both internal and external – so that approved invoices and supplier discounts can be automatically matched against sources of funds
- Buyers, suppliers, funders and funds clearing networks - so that all payments and receipts can be controlled, audited and reconciled.

Audit, reconciliation and KPI reports are provided to all parties, as appropriate to their respective needs.

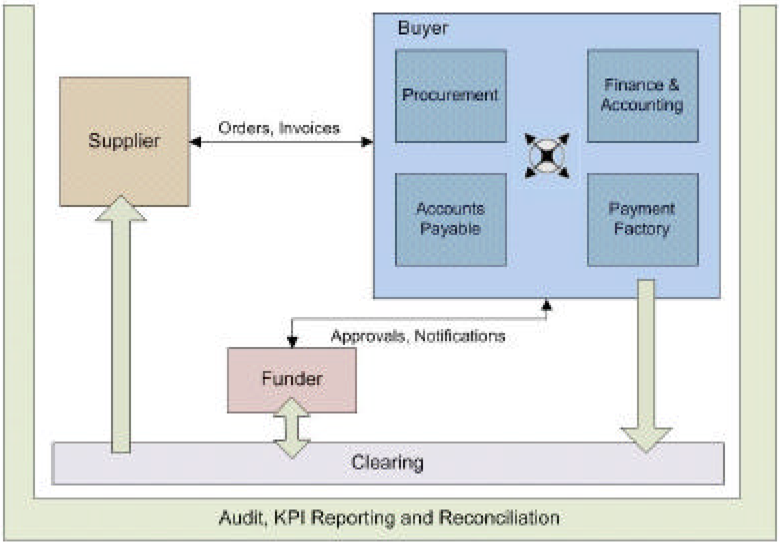

Figure 2: Integrated Financial Supply Chain

Conclusion

Early payment programmes and supply chain finance provide opportunities to exploit the integration of the financial supply chain to provide a benefit to an organisation, both in terms of supplier stability, working capital and bottom-line returns. They require tools to coordinate the supplier base, to share information between different units in the buying organisation, and to coordinate and audit the payment of invoices using a variety of funding sources. An integrated financial supply chain provides the links and controls necessary to enable and streamline the end-to-end process.

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