Financial Management Trend from the View of Value-chain Theory

GUAN Yamei
School of Management, Jiangsu University , P.R.China, 212013

Abstract: The rapid economic globalization resulted in the development of the theory of value-chain management, which led to the revolution in the area of financial management. Value-chain management helps a company gain competitive advantages and succeed in the intense market competition through internal integration across functions and external integration with suppliers and customers. After introducing the orientation and development of value-chain management, the paper examines the impacts of value-chain management on financial management and illustrates operations in financial management via a case study. Finally, the paper discusses the trend of financial management from the view of value-chain theory.
Keywords: Financial management, Value-china, Trend, financial analysis, financial function

1. Introduction

In recent years, competition among companies has become more and more intense with the acceleration of economic globalization and advancement of science and technology. Facing the new competitive environment, companies began to re-examine their core elements such as managerial mechanism, operations flow, and organizational structure in order to establish long-term, inimitable competitive advantage. All of these resulted in the establishment of value-chain management philosophy which also caused revolution in the area of financial management.

In 1985, American Scholar Michael Porter first proposed the concept of value-chain in his book titled “Competitive Advantage”. He explained in his book that competitive advantage derives eventually from the value that firms produce for customers, by offering either relatively lower price or product differentiation. From the value-chain theory perspective, customers, suppliers, and manufacturers are separate but relevant entities and the value to customers comes from the chain. He classified firms’ activities into five basic categories, namely internal logistics, operations, external logistics, sales and marketing, and service, as well as four supportive activities, such as purchasing, research and development, human resources management, and infrastructure. He believed that the value-chain for a firm is composed of all these activities and competitive advantages are obtained through performing these activities more effectively and/or more efficiently than its competitors.

Peter Hines, a professor of the Cardiff University, extended Porter’s value-chain theory. He emphasized that customer needs are the terminal of the value-chain, and that raw material and customers are the new sources for value addition, therefore they should be incorporated into the value-chain system. Hines believed that profit should not be the ultimate goal for a firm. Rather, it is just a byproduct for satisfying customer needs. He also believed that competitive advantage results from aligning all entities in the value-chain, including raw material and customer, to adapt to the changing market.

The theory of value-chain was first applied in managerial accounting in 1990s. However, not until 2003, was the concept of value-chain accounting first introduced in China by Dawu Yan. He incorporated accounting into the system of value-chain management and constructed the initial framework. In December 2003, the Accounting New Area Committee of Accounting Society of China held a symposium to discuss theoretical and practical issues regarding value-chain management and value-chain accounting. As a pivotal part of value management, financial management will be inspired for further development by the introduction of value-chain management theory. However, the studies on value-chain management have only concentrated on theoretical development stages and few can be applied in practice. Up to date, the vast majority of literatures are conceptual and descriptive, yet empirical studies are limited.

2. Impacts of Value-chain Management on Financial Management

2.1 Revolution of Financial Function

Among all departments of a firm, finance department is the only core department that links the stakeholders' interest with operational strategies and operational performance. Financial managers have to make each and every decision based on its potential impacts on the value of a firm. In the past, the primary functions of financial department were daily business, such as journal entry, cost analysis, preparation of financial statements, cash management, as well as financial decision. The traditional financial function put emphasis on budget control and various regulations execution. It also focused on the management, reporting, and control of completed transactions, but often neglected long-term development and value-added activities. However, in the process of company restructure, the impact of financial activities has stood out. Financial functions have been playing a more and more significant role in business strategies, innovation, value management, cost reduction, and investment decision.

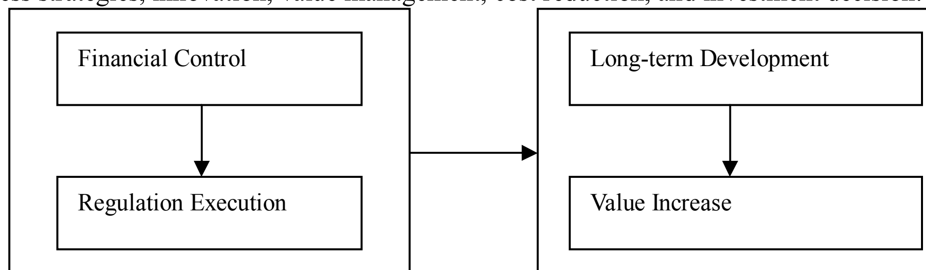

Figure 1. Transition of Financial Management Focus

2.2 Transition of Financial Control from Two-dimensions to Three-dimensions

Generally speaking, the two-dimensional financial management records and reflects historical and present operational performance of a company based on historical data and information. However, in the 21st century, along with the acceleration of economic globalization, companies are facing a more and more complex market. As a result, the operational goal has changed from profit maximization to value increase maximization. The two-dimensional financial management model has been outdated and can not meet the needs for market competition. Therefore, a three-dimensional financial management model of value-chain theory has emerged and focused on the past, the present and the future operations of firms. It is an inevitable choice of investment decision optimization when financial control system is extended to the value increase prediction and decision-making.

Under usual conditions, the value increase of an investment decision can be predicted with Weingartner Model: $\Phi = \max \Sigma\ \Sigma\ Y_{ij}(1+i)^{-1}(xj)$. The constraints are identified in terms of the beginning conditions of the potential investment projects. The NPV of different projects can be calculated to figure out the best investment decision. This process greatly reduces investment mistakes, since value increase analysis has been carried out before the investment decision. Because financial analysis is extended to link value-chain of a firm with those of relevant firms, it also helps improve its management efficiency.

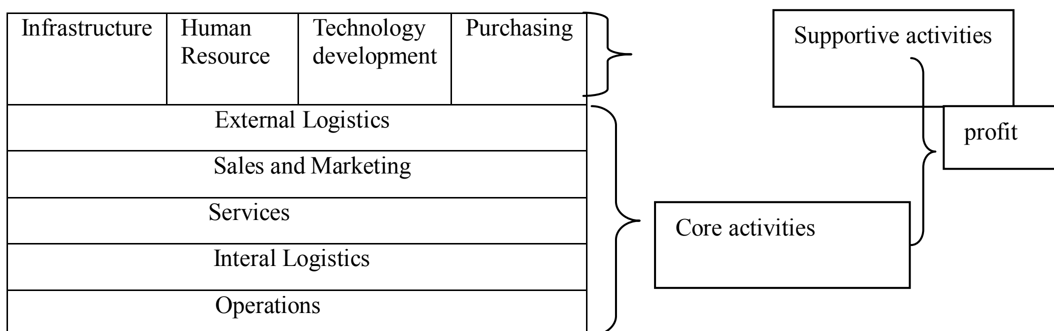

Figure2: Basic Value Chain

2.3 Realization of Financial Optimization via Dynamic Real Time Control System

Real time control refers to the situation where financial personnel uses internet, database, and accounting software as well as the information of timing, materials and cash to monitor, analyze, and even intervene business operations to improve operations efficiency and profits and eventually realize value increase. The presumption of establishing a real time financial analysis system is to minimize the usage of current assets and control inventory. Therefore, a company can maximize its value increase by optimizing retained earnings. To achieve this, a company needs to determine the optimal cash holding and the optimal order quantity.

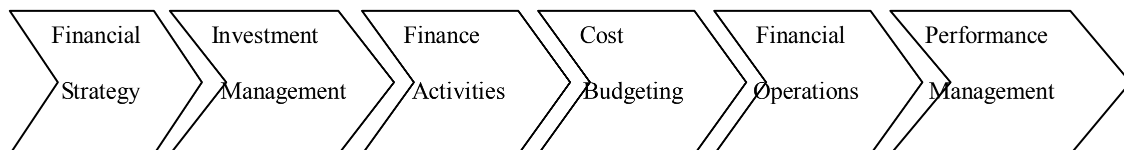

Figure 3. Financial Value Chain Model

2.4 Successful Application of Value-chain Financial Management in Gome Electrical Appliances Holdings Ltd.

Huang Guangyu, a 36-year-old retail-electronics entrepreneur, has for the past two years led Euromoney's list of China's richest people since 2004. He runs a chain of 420 stores in Hong Kong-listed Gome Electrical Appliances Holdings Ltd, and has increased his personal fortune five folds to $1.7 billion in the past several years. In the low profit margin retailing industry, what made Mr. Huang create such a myth catches people's great attention. Gome Electrical Appliances Ltd, founded in 1987, was a retail store for electrical appliances of less than 100 square meters in Beijing. Within 20 years, Gome has become a well-known brand name in China and the company has expanded as China's largest electronics retailer. Now, 15 out of every 100 color Television sets are sold by Gome. At the first glance, what drove the rapid expansion of Gome Electrical Appliances Ltd was its low price sales strategy. However, the fundamental power came from its value-chain system after scrutinizing Gome's operations.

First of all, Mr. Huang focused on the core business and farmed out as much as possible the peripheral businesses. It is common to see Chinese companies, especially state-owned companies, to strive to maintain all the functions and do everything themselves. However, this kind of operations strategy disperses the resources. Consequently, companies can not develop core competences. As such, what a company first needs to do is to break down and restructure its value chain, identify the core and nonessential businesses. Then it should subcontract non-competitive or low-profit businesses and direct its resources to develop competitive value-added activities. Through these the company will achieve better benefits and greater development, which unites the goal of "be strong" and "be big".

Second, Mr. Huang was cautious about supply chain extension and maintained close relationships with his partners. A complete supply chain can be viewed as a potential process of continuous value increase. However, value increase depends ultimately on sustainable competitive advantages of the supply chain partners, rather than simply expanding the value-chain itself. A trend of organizational management is to control risk through inter-organizational long-term cooperative relationship instead of obtaining ownership of supply chain partners.

Third, Mr. Huang has integrated the internal resources and external resources. The decomposition and integration of value-chain should not only target on internal resources of a company. A more important part is external resources integration by using its competitive advantage with a goal of improving resources utilization. The integration can be either a reinforcing type built upon core technology or core operations process, or a complementary type based on of the competitive advantage of business partners.

Lastly, Mr. Huang managed and leveraged financial capital surrounding the core competences. Capital management of a company can be largely classified into two types: financial capital management and capability capital management. The former refers to merge or acquisition with an aim to achieve short-term goals and improve financial statement. The latter refers to merge and acquisition to cultivate, increase, or extend core competences around the core business. The value-chain management requires a company to concentrate on capability capital management, reinforcing its competitive advantages. This is also a common practice in successful companies throughout the world.

3. Value-chain Deconstruction and Financial Management

3.1 Concept of Value-chain Deconstruction

The starting point of value-chain management is to view a company's operations as a process of continuous value increase, during which value increase is realized at different steps of the process. Value-chain deconstruction is to analyze the existing value-chain in a structural manner, identify the advantageous and disadvantageous activities by comparing and contrasting with similar competitors in the industry, farm out its disadvantageous operations along the value-chain so as to focus on and reinforce its competitive advantages, to eventually achieve profit maximization.

3.2 Supporting Theories for Value-chain Deconstruction

Theoretically, value-chain deconstruction is grounded by the economics theory of specialization in the sense that specialization and cooperation improve production efficiency. Practically, value-chain deconstruction derives from re-investigation of traditional vertical integration strategy. Value-chain deconstruction has become a new fashion for business operations. Take Nike for example. Nike has numerous production sites all over the world. Yet, it does not own any of them. With its competitive advantages in product design and sales, Nike has been able to integrate its resources. This not only reduces production cost but also makes it globalization. In the information technology industry, Dell, an American computer-hardware company, is another example that operates successfully on the base of value-chain deconstruction. Dell has limited investment in research and development. However, Dell held a substantial leading in Personal Computer assemble and sale for a long time due to its extraordinary competitive advantages of assembly and direct sales. Its recent slippery behind Hewlett-Packard in the market of personal computer on the other hand revealed the company's operations mistake by refocusing on store-chain retailing which is a huge disadvantage for Dell in comparison with its rivals.

3.3 Financial Management with Value-chain Deconstruction

If we can say that Nike and Dell adopted the value-chain operational mechanism from the right beginning, Ericsson took a different route. The fact that Ericsson exited cell phone manufacturing business indicated that this world telecommunication giant transitioned from the traditional operation model to the new one. The value chain of a cell phone can be roughly broken down into three stages: research and development, manufacturing, and sales. Because of technology dispersion and competition, profit from cell phone manufacturing has become marginal compared with that from new product development and sales. Cell phone production has gradually transferred to developing countries where raw material and labor cost are relatively inexpensive. From the value-chain perspective, cell phone manufacturing can not bring Ericsson rich profit any more and continuing production can even produce negative profit. Just because of this, Ericsson outsourced its majority cell phone production (except the manufacturing in China) to a company in Singapore. Instead, Ericsson focused its resources on new product development as well as post-sale services. This case shows that Ericsson has done a new round of value-chain deconstruction and reconstruction, put more emphasis on research development, design, product launch, and marketing while outsourcing purchasing and production.

4. Conclusion

Value-chain management brings up a new concept for financial management in that financial management also underscores considering the whole picture of business strategy, optimizing and integrating its core elements in operations. It could be speculated that value-chain management will lead the development of financial management to the following directions.

4.1 Trend One: Focus on Value Management

Value-chain management emphasizes that customer value increase is the ultimate target for operations and that a company should cooperate with upstream and downstream supply chain partners to maximize the value. This shed new light on financial management which underlies value management. Financial management is a comprehensive value management. It performs its own functions which are associated with all the activities in operations and the management in all dimensions.

In recent years, research on financial management has switched from studying the outcome to studying the source. That is, the target of financial management is to create value. Born from here is the new value management concept. Value management aims to maximize customer value, which in turn maintains sustainable development of a company. It not only builds up the company image, but also is in line with the inner desire of organizational restructure under new business environment. However, this can not be achieved without the involvement of suppliers who directly determine cost and quality of raw materials. A win-win situation for a company and its suppliers is established via waste reduction, on-time delivery, inventory reduction. This paves a solid ground for low cost production. The core of financial management is to maximize the value of a company. Therefore, the application of value-chain management in financial management will establish long-term sustainable competitive advantage and build up a platform for value maximization.

4.2 Trend Two: Resources Integration and Optimization

From the value-chain management perspective, a company has to integrate and optimize its internal and external resources to obtain and enhance competitive advantages. The vehicle of financial management is capital management, which requires a company to highlight capital value maintenance and increase in all business activities and capital input-output efficiency. Value increase not only relies on optimizing internal resources, but also rests on capital expansion through finance, investment, merger and acquisition.

4.3 Trend Three: Network and Virtualization

The development of computer science and network technology has struck enterprise operations from every single aspect. Companies can formulate dynamic alliances with the help of network technology and form virtual companies. Information technology offers an easier way to restructure operations flow. Value-chain management takes the full advantage of modern techniques (e.g., computer, network) to achieve real time control and real time management. Intranet and internet help improve communication both internally and among supply chain partners, as well as enhance understanding customer needs. Financial management is being transitioned to be conducted on-line, for instance, remote reporting and auditing. Capital turnover can be increased through online cash transfer. Capital utilization can be enhanced by investing in stocks and foreign currencies. Additionally, online payment transfer with upstream and downstream partners can improve work efficiency.

References

[1] Andrews K. The Concept of Corporate Strategy. Homewood,IL:Irwin,1971,p25～34.

[2] Mishael E Porter. Competitive Strategy. Free Press,1980,p133～201.

[3] Prahalad.C.K. ＆Hamel.C. The Core Competence of the Corporation .Harvard Business peview,1990, p34～79.

[4] Warnecke HJ. The Fractal Company: A Revolution in Corporate Culture. Heidelberg, NewYork: Springer Verlag,1993. P47～91

[5]Michael Hergert, Deigan Morris.Accounting Data for Value Chain Analysis. Strategic Management Journal,1989(6), p45～67

The author can be contacted from e-mail : guanyamei@sina.com