Nowadays, treasurers are not just responsible for the way cash is invested and the returns it delivers. They are also increasingly involved with the strategic and operational issues associated with their organisation's working capital. This is because they need to have an accurate, reliable and robust cash flow forecast. But they face a challenge in understanding the complexity of the cash conversion cycle – that is, whether cash is received from customers or clients and paid to suppliers and contractors efficiently across the organisation.

The traditional approach

Let's take the trade working capital aspects of the cash conversion cycle as defined using the following traditional calculation method:

- Days inventory outstanding (DIO) = inventory/(cost of sales/365)
- Days sales outstanding (DSO) = receivables/(sales/365)
- Days payable outstanding (DPO) = payables/(cost of sales/365)
- Therefore the cash conversion cycle (CCC) = DIO + DSO - DPO

The important point here is that if the total for the cash conversion cycle is positive (the only negative number in the above calculation is the figure for DPO), then you could have a liquidity gap that needs funding since cash is exiting the organisation faster than it is being received. For this reason, the efficiency of the processes involved in the cash conversion cycle is crucial, as a bottleneck, restricted flow or severance of cash flow at a critical point could cause severe embarrassment to, or even the complete failure of, the organisation.

But the above calculation is, of course, subjective. It is subjective because in the case of inventory, work-in-progress can be a system-generated figure. Cost of sales could also be calculated using the percentage of completion method, which is particularly prevalent on construction and long-term contracts. In addition, using 365 days in a year when most organisations have cyclical business patterns makes comparisons even on a quarter-by-quarter basis somewhat challenging.

Hence the traditional approach, as adopted above, has led to management teams implementing short-term measures. For instance, a CFO might request that cash is paid out more slowly, thereby increasing DPO and building up more cash in the bank account. Accounts payable might delay the payment run to suppliers and contractors (and even employees in some cases) and the purchasing function might attempt to negotiate longer payment terms with suppliers.

But while these measures only have a 'one-off' impact, they can be detrimental in the longer term since they generate inefficient processes that increase transactional costs throughout the business. Why? Well, suppliers start to withdraw their services, slow the delivery of products or actually curtail contracts on the basis that they do not feel confident they will be paid on time. This may mean goods cannot be manufactured, which could in turn mean that customer demand for an item at a given point in time is not met, generating a cash income shortfall and impacting treasury's cash forecasts.

A new approach

But a more mature, longer-term strategy for cash efficiency exists, which relates to the complete end-to-end processes associated with the order to cash (O2C)/demand chain (previously identified as DSO) and the purchase to payment (P2P)/supply chain (previously identified as DPO). So what is this new strategic approach?

In the demand chain, the treasurer now needs to review the whole process, including: entry into new markets, new territories and new sectors; the bid/no bid scenario; the terms and conditions of sale; and the straight-through reconciliation (STR) – not straight-through processing (STP) – of cash receipts.

Within the supply chain, the treasurer needs to understand the corporate social responsibility aspect of dealing with certain suppliers (for example, labour costs); the risk scenarios of procurement, ie from overseas locations; the terms and conditions of purchase; and STR of payments from the company's bank account.

In a business-to-business (B2B) environment, traditional methods of holding back payments to suppliers have now been replaced by dynamic discounting and supply chain finance models that assist all parties in robust cash streams. The traditional methods could lead to 'liquidity gaps' and even the need for short-term injections of funding, but such challenges may be consigned to the past as cash streams become more robust and all parties have confidence in the final objective.

Furthermore, methods of tackling errant customers by chasing monies due through debt recovery agencies and/or credit control departments (particularly in product, project and service-based B2B relationships) are no longer fit for purpose. Instead, it is better to establish internal processes where receipts are aligned to payments to suppliers, so that customers are not paying in tranches, and not on ad hoc invoices that are sent by post, but rather according to contractual commitments.

Contractual commitments with customers need to be on a more focused basis. By offering

Mind the gap

TREASURERS NEED TO TAKE A LONG-TERM VIEW OF STRATEGIC CASH MANAGEMENT TO AVOID AWKWARD FUNDING SHORTFALLS, SAYS JOHN MARDLE

STRATEGIC CASH CONSIDERATIONS

THE DEMAND CHAIN (THE THREE Ds)

◆ **Differentiation – which customers are strategically important to you today and tomorrow from a cash-efficient point of view? Who pays the largest amounts promptly?**

◆ **Debtor development – can you structure current and future cash streams more efficiently with certain customers, in certain markets, to ensure full payment is received in a timely manner?**

◆ **Default – what is your strategy regarding the customer, the sector or even the whole organisation should a major default occur? What communication process do you have in place to notify shareholders and the wider investor community of a liquidity gap?**

THE SUPPLY CHAIN (THE THREE Cs)

◆ **Certification – set up web portals so suppliers/contractors can pre-qualify themselves as fit to bid for contracts.**

◆ **Categorisation – categorise suppliers/contractors so the company has guidance as to which ones to use from a sole-source, dual-source or multi-source point of view. Consider whether future market developments will render the current requirements obsolete and mean alternative suppliers/contractors need to be added to the list.**

◆ **Classification – define the measures according to which a supplier/contractor is monitored based on a series of metrics and the cash efficiency scenarios generated.**

favourable monthly payment terms with one-off fees, rather than high monthly payments, customer retention and even customer take-up could be increased. There is also the option of structuring contractual commitments related to receipts by:

◆ Geographical location;

◆ Structuring service-level agreements with certain customers where receipts are paid monthly and these are complemented by performance milestone payments; and

◆ Linking key performance indicators (KPIs) to timelines that could trigger receipts of cash (incentives/bonuses) to organisations that meet or improve on pre-agreed KPIs.

Of course, the overriding consideration with cash management is for the company to have sufficient funds in its bank accounts for payments to occur without hindrance. Pooling and centralisation of creditors' payments could assist in this alignment of receipts and payments.

As the cash conversion cycle becomes more efficient, it effectively reduces the funding that is needed to support the company's working capital commitments. It also reduces the company's carrying cost of capital. This, in turn, can enable more attractive pricing of products, projects and services, and therefore lead to higher profits, dividends and internal investment such as research and development, marketing, etc. In other words, the company should approach banks and financial institutions for more funding of working capital on the basis that it wishes to support new growth, not invest in antiquated, old-fashioned practices that just fund inefficiencies in the cash conversion cycle.

CASH EFFICIENCY – FIVE QUICK WINS

Ways that treasurers can help to make their organisation's cash conversion cycle more efficient:

◆ **Create a checklist of the current terms and conditions associated with both customers and suppliers to assess whether the current receipts and payments profiles meet the strategic objectives of the organisation.**

◆ **Review your accounting systems to understand whether they can adapt to new strategies such as dynamic discounting or supplier chain financing.**

◆ **Deliver a contract risk register or matrix that identifies liquidity gaps, particularly where intercompany or intracompany accounts are used.**

◆ **Review your scenario planning, which introduces cash management and contract management on a major customer or major supplier basis. What if a supplier is not paid in a timely fashion? What if a customer defaults?**

◆ **Produce a monthly working capital overview that reflects the efficiency of each strand of the financial supply chain – namely the demand chain, the supply chain, the stock and the work-in-progress chain – over a rolling 18-month period (nine months previous and nine months forecast).**

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