A QUESTION OF BALANCE

CHRIS HALL TALKS TO THREE LEADING TREASURERS ABOUT HOW WORKING CAPITAL IS MANAGED IN THEIR RESPECTIVE FIRMS, THE INFORMATION USED AND THE KEY PROCESSES AND CONTROLS EMPLOYED.

As the part of the treasurer's role that brings him closest to the firm's operating units, working capital management (WCM) is also the area influenced most by its business environment. These sectoral variations are evident amongst the three companies whose treasurers agreed to discuss their working capital practices and principles with *The Treasurer*.

Defined traditionally as the amount of stock/inventory carried by a business plus the amount owed by debtors less that owed to creditors, WCM deviates in practice for two of the three treasurers interviewed. As a mass-market food retailer, debtors play a minimal role in Tesco's WCM priorities, whilst stock is not a major concern for Cordiant, the advertising and marketing services firm for which "our people are our greatest fixed asset", according to Corporate Treasurer Steve Wilson.

On the other hand, diversified engineering group FKI makes and sells products in a number of different markets, and the group is effectively confronted with different WCM issues across four distinct businesses.

CORE BUSINESS AIMS. One characteristic that does unite the three treasurers is how close they consider working capital to be to the core aims of their respective businesses.

In Tesco's case, failure to manage working capital means failure to deliver to customers the right products in the right quantities at the right time. "Our guiding principles for WCM are our core business values, because working capital management is so integral to our core processes. To look at WCM in isolation is wholly inappropriate, it should be all about improving business efficiency," says Bob Howell, Group Treasurer at Tesco. The firm's two principal values – 'No one tries harder for the customer' and 'Treat others as we wish to be treated ourselves' – both find expression in Tesco's focus on efficient supply chain management and replenishment processes to reduce costs while optimising availability.

For Wilson, the nature of Cordiant's business also heightens the need to control working capital vigilantly: "In a business where we have no major fixed assets or stocks effectively working capital is our balance sheet. So if accounts payable and receivable get out of kilter we are faced with some major cash outflows, hence the need to scrutinise monthly reports closely to identify any potential problems."

SHARED RESPONSIBILITY. Of necessity, responsibility for WCM is typically shared between the treasury department – which sets policy parameters, offers guidance and has at least a hand in the annual budget or financial plan – and the operating units, which are held accountable for day-to-day execution of policy. Cordiant's Wilson says treasury plays an increasingly important role in monitoring and encouraging best practice. "We are not a bank and as such we should not be financing our clients," he asserts. "Thus we encourage operating units to ensure that the receiving client pays them in time for them in turn to pay their suppliers. This means that the processes and controls of working capital management go to the heart of the business relationship; working capital management starts when a new business prospect walks through the door and terms of payment are discussed."

At FKI, the four divisions are fully accountable for their individual trade working capital levels, ie inventories; trade receivables and trade payables; with total working capital, including accruals, prepayments and intercompany trade balances, managed at group level. "The distinction is made chiefly because trade working capital is a direct function of how the company is operating and can be directly controlled at business unit level," according to Robin Graham-Adriani, FKI's Group Treasurer.

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BUDGET. With WCM seen as such a key financial driver, the framework for controlling and monitoring working capital is typically underpinned by the firm's financial plan or budget.

Partly to promote good efficient WCM, Cordiant recently installed a new budgeting mechanism. Each unit is required to budget their

working capital levels for each month during 2002. "This allows us to a set a target – represented as a percentage of revenue invested in working capital – for the year. The target is volume-adjusted so that if the business grows and needs more working capital, these needs can be met as long as the increase is in proportion to levels previously agreed," explains Steve Wilson. The newly-formalised approach replaced old methods which were deemed ineffective. Use of straightforward debtor-over-creditor ratios, for example, was considered inappropriate as they did not reflect the volume of working capital invested.

Cordiant also monitor aged debtors and aged levels of work in progress. "Typically, aged debtors is calculated as the percentage of debtors older than 90 days, but this varies according to local market practice. The key is to ensure that we are being paid according to the same schedule as we are paying our creditors," says Wilson.

FKI use a profit plan programme that includes explicit incentives and penalties related to WCM. Each January/February, the firm's three executive directors devote five full weeks to the planning process for the new financial year. This involves presentations from each business unit in which all operational plans for the forthcoming year are justified. Individual units' plans vary from year to year with factors such as capital expenditure, M&A activity, market conditions and foreign exchange exposures amongst the larger influences. For example, if a particular energy technology market is expanding, this will be reflected in tougher targets for the relevant units in that division. Macro-economic conditions are also factored in using forecasts on GDP, inflation and commodities prices from key banks.

Remuneration policy is set at group level and includes bonuses which are linked to achievement of unit or group targets rather than personal objectives set by immediate superiors. Managers at group, divisional, or business unit level are only entitled to a bonus if profitability and cashflow targets for their operations are met. "If they miss it by a whisker, too bad; this means everyone is chomping at the bit to ensure that the unit is performing well enough to get to that level," says Graham-Adriani, "It also means managers are hit in their own pockets if they do not perform to set working capital management targets."

A significant incentive is the working capital interest charges levied on business units' actual-to-plan working capital variances. Such variances attract a charge or credit equivalent to 10% pa (debit or credit and levied monthly) which is included in the operating profit of the relevant business units. This places a strong emphasis on working capital control since business unit operating profit is the key driver in determining local management's bonuses.

Stock availability is the main way Tesco judges the success of its WCM processes. If information collected by customer surveys or online orders from Tesco.com reveals a problem, this is filtered into the firm's ongoing process for ensuring continued improvements in efficiency. Dubbed the 'steering wheel', this is Tesco's mechanism for ensuring that the group as a whole is taking the necessary actions to reach its key objectives and is divided into a financial plan, customer plan, operations plan and staff plan. For example, the operations plan includes responsibility for efficiency of replenishment, which is reviewed on a monthly basis. Below this level, the distribution team and supply chain team all have 'steering wheel' objectives which ensure, for example, that problems arising in stock control are identified, analysed and resolved.

INFORMATION. In order to pick up early signals of potential problems, both FKI and Cordiant rely primarily on detailed month-end reports, as well as shorter-term cash forecasts.

'CASH FORECASTS ARE AN IMPORTANT TOOL IN MANAGING WORKING CAPITAL AS THEY ALLOW US TO SPOT A PROBLEM BEFORE IT HAPPENS'

All FKI's units submit a weekly cash report and sales & orders report. The cash report shows operating cashflow and cash balances by unit and provides an early "heads up" of any trends in working capital. In addition, the units' month-end financial reporting provides a great deal more information on working capital including full details of the composition of inventories, aged trade receivables and all related provisions. As part of this month end-reporting process, working capital ratios are also monitored, consisting of 1) trade working capital to sales, 2) inventory days, 3) trade receivables to sales (ie debtor days) and 4) trade payables to purchases (ie creditor days).

Graham-Adriani typically confines himself to monitoring the headline monthly borrowing/cash balances but, if a problem presents itself, he will then look at the other WCM indicators. For example, a rise in stocks of raw materials might be an early indicator of a tail-off in demand or just a change in the mix of contracts to more in-for-out type orders rather than long-term contracts.

Cordiant accesses up-to-date information via both regular phone calls to the larger entities in the group and internet-based reporting. "Cash forecasts are an important tool in managing working capital as they allow us to spot a problem before it happens (rather than in retrospective monthly reports) by identifying unexpected cash outflows," says Wilson. Daily updates on cash positions from all units help identify any short-term trends or changes that could cause problems further down the line. Operating units have recently started inputting the data themselves via the group's intranet, giving the treasury more time for analysis. "The next step will be distributing different types of working capital analysis back to the operating units over our intranet," Wilson explains.

Tesco takes a slightly different approach in that its main source of information is the customer. Customer surveys and panels have long been used by the group to monitor customer satisfaction with stock availability, but only since the establishment of its online ordering service has Tesco been able to compare customers' shopping lists with on-the-shelf availability. "In the past, if something wasn't on the shelf we never knew whether customers wanted to buy it or not," says Howell. "With the online business, we can find out exactly what they want so it is pretty clear if we have lost a sale. As a result, online has really added to our passion for availability."

BENCHMARKING. Whilst controls processes and information systems help ensure that a firm is meeting its own objectives, they do not necessarily ensure that the treasurer is following industry best practice. Benchmarking against competitors is seen often seen as unsatisfactory. Typicallly, FKI's main measure is to map actual figures against plan and previous years, but the firm also tries to benchmark ratios against competitors. "It is hard to produce true like-for-like comparisons, but the executive directors take a very keen interest in what the competition is up to," says Graham-Adriani.

Robert Statius-Muller of consultants Greenwich Associates agrees that benchmarking is not easy: "Firms can only really benchmark working capital management within their own industry, and narrowly even within that. Annual reports do allow the outsider a reasonably good level of insight into a firm's WCM, partly because inventory accounting is now fairly standardised."

Tesco's Howell makes comparisons with competitors, not only on creditor management but also on capital structure. According to Howell, the intensive use of capital required to compete in today 's more sophisticated food retail market has increased WCM's role in the funding equation. "On the finance side, overseas competitors often rely on funding from creditors and can benefit from higher credit ratings as a result," he asserts. "It is usually cheaper to fund suppliers ourselves. Comparisons with other retailers are difficult as you are rarely comparing like with like, due to different accounting conventions overseas. And whilst it is not our strategy to do so, a lot of debt can be hidden off balance sheet via leasing or use of creditors 'funds."

THE KEY. FKI's Graham-Adriani characterises the key to good working capital management as "a disciplined and well researched planning process followed by accurate and timely reporting of relevant information coupled with the ability to take rapid action where required." This recognises that effective control of WCM demands commitment at all levels. Policy documents and budgets are reinforced by site visits, presentations and regular advice to ensure the message is understood throughout the firm.

At Tesco, an understanding of WCM influences the most mundane of operations such as ensuring that a lorry is stacked in the right order so stock can be put on the shelves as quickly as possible. Cordiant's Wilson acknowledges the need for a proactive approach: "Helping staff to understand the difference between billings and cash requires an ongoing education process and we never turn down an opportunity to attend a regional finance conference to reinforce the message."

At each stage of WCM, from framing policy to collating data and monitoring operating processes, close co-operation with business units – and awareness of overall company objectives – remain fundamental.

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FKI plc is a FTSE mid-250 engineering group organised into four operating divisions (FKI Logistex, Lifting Products and Services, Hardware and FKI Energy Technology). Logistex (which includes baggage-handling, automated conveying and sortation of goods), is the largest of the four divisions. The hardware division is one of the largest manufacturers of hardware for doors and windows etc. in the US. Energy Technology produces turbo generators and ancillary electrical equipment. Operations are worldwide but with heavy concentrations in North America (approx. 60%), UK (approx.20%), Continental Europe (approx. 15%) and Australasia (approx. 5%). It has a very small head office function consisting three executive directors plus senior tax, treasury, accounting and legal staff.

Robin Graham-Adriani explains the different approached to WCM taken across FKI's four divisions...

FKI is run according to the lines of business within each of the four divisions. This is essential to ensure proper focus on each relevant business cycle from the supply chain to the after-sales customer service. Geographical co-ordination is normally restricted to overlay arrangements such as cash management and efficient taxation arrangements.

It is important with a group as diverse as FKI to bear in mind the business-related differences between the four divisions. Debtors, for example, are dealt with differently. We often build in the cost of insuring the transactions. Exports to customers in distant or unfamiliar markets normally demand use of credit insurance or letters of credit to protect against bad debts. This is not an issue for some of the businesses, particularly in Logistex and FKI Energy Technology which service largely blue-chip clients.

'IT IS IMPORTANT WITH A GROUP AS DIVERSE AS FKI TO BEAR IN MIND THE BUSINESS-RELATED DIFFERENCES BETWEEN THE FOUR DIVISIONS'

SCHEDULING PAYMENT TERMS. Most differences stem from the type of business rather than the type of client. For example, when installing a baggage-handling system, the nature of the contract dictates that you are not going to get paid 30 days after submission of an invoice. It can take over two years to install and so stage payments are required. In the energy technology business, a contract might specify 100% payment on delivery, or alternatively a reasonable up-front payment with the order followed by a further final payment on delivery or commissioning.

In Logistex there may be a lot of stage payments throughout the contract, eg progress payments and bullet payments at the end, whereas in hardware payment is due 30 days after the invoice has

been sent. We generally try to structure longer-term contracts in such a way as to remain slightly cash positive throughout duration of the contract. We acknowledge the hidden danger of receiving large up-front payments which, although great from a cashflow perspective, can make one over-reliant on a continual flow of new contracts to fund the completion of existing ones. In this way our funding and working capital levels are not overly exposed to periods of recessions/booms.

DEALING WITH A DOWNTURN. In common with a lot of other companies we have recently experienced a small fall-off in business with some cash outflow on working capital. This outflow stemmed mainly from reductions in trade creditors, down payments and payments on account received from customers, mostly from Logistex, reflecting the downturn in order intake and deferral by customers of large projects.

Because stage payments and payments on account cannot always be fully recognised as revenue on incomplete contracts, we can have a relatively large creditor amount permanently sitting on the balance sheet for 'payments received on account'. In November 2001, we reported half-year profit figures down around 15% and a modest rise in working capital – in part due to the high level of down payments involved in the Logistex business.

At FKI, there is a strong ongoing effort to cut costs and realise efficiencies. Weekly cash reports are being particularly closely monitored to ensure inventory and stock is not piling up. In a slowdown, it is not a matter of changing policies, but ensuring that sound existing policies are followed and that people really apply pressure in the right areas. Bearing in mind our expectation of a strong rebound from the airline industry, we aim to flex our cost base according to demand, offsetting any adverse working capital impacts by ensuring we support group profitability through cost-saving initiatives. Elsewhere, our US hardware division is looking on the supply side, for example we are looking at new ways of sourcing raw materials, with units clubbing together wherever possible.

Tesco is the UK's leading food retailer with 16.2% market share. Its 678 stores employ 200,000 staff. The group's growing non-food ambitions are reflected in its rapid overseas expansion as a general retailer. It is already market leader in five of its nine non-UK markets (Ireland, Thailand, Czech Republic, Slovak Republic and Hungary). It expects 50% of its retail space to be located overseas in the near future.Tesco.com is the world's largest grocery home-shopping service with annualised sales of £300m.

Bob Howell explains how Tesco deals with the large number of creditors that are the natural consequence of retailing the widest possible product range to customers....

Whilst adhering to our core principle of treating others as we would wish to be treated ourselves, our policy of prompt payment is tempered by a certain degree of schizophrenia.

It is common in this sector to have a high number of suppliers. But whilst continental competitors, especially those that stock a higher proportion of non-food items, might pay suppliers within 70 days on average, typically we pay within 30 days. One reason for these longer credit terms is the higher proportion of larger, non-food suppliers to continental-style hypermarkets, but we also suspect that suppliers are differentiating between customers on payment terms because they are not allowed to differentiate on price. For Tesco to adopt similar practices would be to take £2bn in funding from our creditors; with debt of £3bn at present you can see how potentially significant that is. The attraction of this kind of supplier finance is that it reduces net investment costs, therefore improving returns on capital employed. It would also reduce our debt levels and help our debt rating.

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On the other hand, it does not make sense over the longer-term for us to push funding onto a weaker credit that would find it more expensive to carry the burden. With particular concern for the cashflow position of our smaller suppliers, we believe there is a good argument for paying promptly. After all, Tesco is only as good as the range and price of the products it supplies.

With larger suppliers there is more of a debate. Our standard terms are for payment at the end of the month following the month of invoice, but there are instances where historic practices and industry norms force us to diverge from this. When pushed to pay early we tend to be resistant and analyse the position base on weighted average cost of capital rather than the marginal cost of debt, which obviously leads us to a longer period of credit.

On the one hand, we are reducing costs by taking on the costs that we can carry the cheapest, but on the other hand we don't want to go further out of kilter with our international competitors. To be honest, the treasury department probably doesn't help the situation because we can see how our rivals' debt ratings are helped by the terms they work to. Although they are incurring extra costs through the amount of funding that comes through their suppliers, they are saving money on the rest of their debt by their improved credit rating.

REACHING CRITICAL MASS. In most overseas markets we are more of a hypermarket than a supermarket chain and sell a greater proportion of non-food items. Whilst the return on capital is much the same as for food, stock turnover is longer and non-food retailers try to obtain payment terms reflecting this. Non-food items can lead to positive working capital, ie stocks are larger than creditors, so it makes sense for us to improve our return on capital invested in the non-food business by pushing out payments to suppliers. In our overseas businesses the supply chain also needs to be managed differently at present because we cannot introduce centralised distribution until we have reached critical mass. Our strategy is to capture greater market share in fewer regions in order to develop more efficient stock management processes than our competitors.

The overseas business Finance Director (FD) is responsible for effective working capital in a particular region. And as banker to the overseas businesses, the centralised treasury also acts as a control on working capital management, releasing additional funds to overseas FDs only when justified on business grounds."

Cordiant Communications Group is a global advertising and marketing services company. Listed in New York and London, it has more than 10,000 employees in more than 216 offices spanning 80 countries. Due to the number of different business brands within the group – each with their own networks and management structures – working capital management is very decentralised in keeping with the management structures of the organisation as a whole.

Steve Wilson explains how Cordiant ensures that terms with large global clients and small independent suppliers are kept in synch...

Partly because Cordiant does not have a uniform management structure, treasury tends to maintain relationships with regional, network and local management as appropriate, with the emphasis on regular daily contact with the highest revenue-earning businesses in the group. Although reporting lines vary, we do have formal monthly working capital management meetings in which the network and regional CFOs discuss with treasury any issues arising in the previous four weeks. We also have a more high profile Quarterly Business Review, attended by the group CFO and the network CEOs, which covers a broader range of topics but can include WCM issues if necessary. Typically, detailed discussions are left to the monthly meetings.

BALANCING CLIENT NEEDS. One important aspect of WCM for us is flexibility as our clients all tend to work in different ways. For example, larger clients use a purchase order mechanism and will refuse to entertain any unsupported billing – but will still expect to call up at 11pm to demand a new piece of work. So discipline is required on both sides. In particular, we need to keep good control of work in progress, via timely billing, over the course of a working relationship and particularly on longer-term projects. For these we encourage stage payments so that units can cover their costs as they go along rather than billing at the end.

Historically, a risk peculiar to advertising is the exposure created through handling client's payments to media firms. Placing an advert in the middle of the World Cup final for example creates a large cash exposure but only a tiny percentage represents our revenue. Nevertheless, it is we who are chased for payment, not the client. Now that we have a stake in a media-buying firm, our involvement is lessened. It also helps that the industry is moving from a commission basis (ie being paid a percentage of the client's overall media spend) to a monthly retainer fee where budgets and service levels are agreed upfront.

'OUR BUSINESS IS ALL ABOUT MEETING THE CLIENT'S NEEDS. SOMETIMES WE HAVE TO MAKE IT CLEAR TO ACCOUNT HANDLERS THAT MONEY IS PART OF THIS PROFESSIONAL BUSINESS RELATIONSHIP'

In terms of dealing with our own suppliers, it is important that terms of business marry up with those agreed with clients if at all possible. This can be difficult due to the number and range of suppliers we use. For example, photographers are often small businesses that need to be paid in advance; we need to build this into the way we bill clients. Whilst the move to retainer fees should help regularise our inflow, monthly fees typically only fund salary payments; we still have to bill on costs to clients. This can be difficult if a client will only entertain billing of 100% of total costs. Use of upfront or stage payments are required to ensure our costs are covered in good time.

Our business is all about meeting the client's needs and sometimes we have to make it clear to account handlers that money is part of this professional business relationship. We are serving the client well and should be properly remunerated for it. Thus payment terms should be discussed as early in the process as possible. All new contracts have to be signed off by the local finance director, so it is important that local finance staff are involved in the drafting stage, otherwise terms can be difficult to change at a later stage. If for this reason alone, I believe that finance staff should be involved at the earliest stage in all new business.