HOW TO AVOID THE PITFALLS

STAGGERING AMOUNTS OF CASH ARE LOST EVERY YEAR BECAUSE OF POOR WORKING CAPITAL PRACTICES. **DAVID LOCK** OF REL CONSULTANCY FOCUSES ON THE TEN MOST COMMON AREAS TO WATCH OUT FOR.

Poor working capital management is the heart disease of the corporate organism. Insidious damage builds up quietly over time, and only after serious harm has been inflicted do managers finally recognise the true extent of the problem. By then, customers are not paying bills, suppliers are levying interest charges or imposing credit sanctions, inventories are increasing, and every month-end has become a mad scramble to raise cash – in short, a crisis erupts.

But it does not have to be this way. By making working capital management a priority, companies can recapture significant sums of money that can be put to better use in research and development, in making acquisitions, in effecting share buybacks, or even in raising the dividend. Soon, they can find themselves generating more cashflow with less working capital – the surest and often the quickest way for most companies to create shareholder value.

The sums involved can be staggering. One Fortune 25 company was able to generate an additional $5bn in cashflow in just two years through a working capital initiative that included overhauling its worldwide billing and collection processes, implementing a formal payment dispute management process, and rewarding its sales force for helping to avoid payment disputes. Yet another company, working on a far tighter schedule, liberated more than $200m from working capital in just four months. It implemented best practice business processes for both revenue and expenditure management, an undertaking that involved standardising and rationalising its customer and supplier payment terms, rewriting its payment and collection policies and linking its procurement and accounts payable processes. Both companies introduced metrics that allowed their managers to monitor progress in these areas on a real-time basis.

Ironically, working capital management is more than a numbers game. Its levers – those that impact working capital the most, anyway – are not financial in nature but operational. When customers fail to pay their bills because they are receiving substandard products, it is operations, not finance, that has a problem. When customers turn to other suppliers because goods are not being delivered on time, it is again operations, not finance, that has a problem. The upside is that most improvements in working capital management come from improvements in operations, which means that companies that improve working capital management also enjoy more efficient supply chains, happier customers and satisfied suppliers. Working capital management is not just a driver of balance sheet data, then, but a driver of revenue and expenditure, a driver of cashflow and a driver of customer service.

To follow are 10 of the most common working capital management mistakes that businesses make:

- **Waiting for a crisis before trying to improve working capital processes.** Because it is viewed as a mundane accounting chore, the executive team quite innocently ignores working capital management in favour of matters that seem more pressing or interesting: mergers, acquisitions, divestitures, or perhaps a new product launch. Working capital management goes to the heart of a company's operations. By waiting for performance indicators to deteriorate, management often jeopardises the very backbone of the company.

'THE SUMS INVOLVED CAN BE STAGGERING. ONE FORTUNE 25 COMPANY WAS ABLE TO GENERATE AN ADDITIONAL $5BN IN CASHFLOW IN JUST TWO YEARS'

- **Believing that working capital management problems can be resolved by the chief financial officer alone.** As noted earlier, the levers that impact working capital most are operational in nature, not financial. They relate to the quality of the company's products or services, the timeliness of their delivery and the levels of customer service that accompany them. Accordingly, working capital management initiatives must also extend to the sales force, the purchasing department, production facilities and loading docks – as well as the accounts payable and accounts receivable departments.

☐ CHARACTERISTICS OF COMPANIES WITH SUPERIOR WORKING CAPITAL PERFORMANCE

Just as the same mistakes crop up again and again in companies which employ substandard working capital management practices, so do companies with superior practices share many common traits. Among these are:

- policies that are easily understood by both operational managers and finance personnel;
- processes that are sensitive to how they impact the entire organisation, including customers and suppliers, rather than just one function, automated where possible to reduce the potential for human error;
- people who are trained and rewarded for their contribution to working capital performance;
- information systems that are flexible enough to adapt to the organisation's unique processes or requirements without force-fitting; and
- performance metrics focused on the balance sheet, as well as the income statement.

- **Waiting until debts become overdue before contacting customers.** By postponing contact with customers until a debt is overdue, companies put all hope of being paid on time into the hands of an outside party. A better solution is to categorise customers according to the value of their business and then focus collection efforts on those who owe the most. Specifically, contact the minority of customers who generate the majority of receivables before, not after, their payment due dates. This allows you to immediately address any problems that have the potential to delay payment. Not only will receivables decline, but customer service levels will improve.

- **Handling outstanding disputes in a reactive rather than proactive manner.** In those instances where a customer has disputed the payment of an invoice, companies too often respond in a haphazard manner that varies from incident to incident. A better solution is to implement a systematic, event-driven dispute management process in which you assign resolution responsibilities to specific individuals, and escalate those responsibilities to increasingly senior employees when outstanding disputes remain unresolved beyond a pre-defined resolution timescale.

- **Extending supplier payment terms without considering the opportunity to secure discounts for earlier payment.** Stretching out payments to suppliers is not necessarily a bad idea – in some cases, it can be quite rewarding. But it can also become a dangerous habit. If you buy into the argument that there is no such thing as a free lunch, it is easy to imagine that, over time, those extended payment terms will be reflected in the cost of the goods and services you are buying. Ultimately, you may give faster-paying competitors a cost advantage that could be difficult to overcome. The solution? Never negotiate extended payment terms without entering into comparable negotiations about potential discounts that could be secured for early payment – only then can your company make an informed decision on the value of either strategy.

- **Rewarding sales personnel on revenues booked, without considering the quality of those revenues.** Paying sales commissions as soon as revenues are booked makes a lot of sense – until orders cannot be filled from inventory or are billed incorrectly, leading to payment disputes. For companies that typically fill sales orders quickly – within days, for example – withholding sales commissions until revenues are billed or even paid may be reasonable. Companies with longer lead times between sale and delivery should consider retaining a portion of each sales person's commission (for example, 30%) pending receipt of payment.

- **Delaying the issue of credit notes to correct invoicing disputes.** Why risk making a bad situation worse? Once your company has concluded that it needs to credit a customer account to correct a billing error, or adjust for a shortfall in product quality or service, the credit should be applied promptly. To do otherwise is a mark of poor customer service and could prompt customers to withhold payment of their entire account. In worst-case scenarios, delaying the issue of credit notes could weaken your customers' trust in your company and drive them into the hands of competitors.

- **Trying to achieve a 100% level of customer satisfaction from inventory.** Every customer wants prompt service. But prompt service means different things to different customers under different circumstances. Where one customer may need goods for next-day or even same-day delivery, another may be perfectly satisfied to receive shipment within a week. Still another may be happy to receive a portion of the goods ordered next day, so long as the balance of the order is filled within two weeks. By attempting to have all orders delivered in full from inventory in one shipment, companies will often saddle themselves with excessive levels of inventory, the downfall of which can be far-reaching. In addition to tying up cash for the inventory itself, it requires expenditures on unnecessary floor space and all the attendant costs of operating that space.

> 'WORKING CAPITAL MANAGEMENT IS NOT JUST A DRIVER OF BALANCE SHEET DATA, BUT OF REVENUE AND EXPENDITURE, OF CASHFLOW AND CUSTOMER SERVICE'

- **Equating improvement in days sales outstanding (DSO) with improvement in cashflow.** As a savvy manager, you know that rising sales do not mean much if they are not accompanied by rising amounts of cash flowing into the corporate coffers. Accordingly, you look beyond the sales figures to days sales outstanding (DSO), for example, total receivables divided by total credit sales for the period being analysed, multiplied by the number of days in that period. The lower the DSO, ostensibly, the faster your company is converting receivables into cash. The danger in this analysis is that DSO can also be improved by issuing credit notes to clear disputed items – a practice that can make all the sense in the world when the reasons are legitimate but does not generate additional cash.

To get a truer picture, make sure lower DSO numbers are not being generated by wanton illegitimate issuance of credit notes. In addition to reviewing the actual volume of credit notes, compare actual DSO, as described above, with best possible DSO, which is the level of DSO that could be achieved if all customers paid precisely to agreed payment terms. If all sales were made at 30 day terms, for instance, the best possible DSO would be 30.

The critical performance measure is the gap between best possible DSO and actual DSO. Measure it, and break it down into three components: disputed debt (for example, the customer says the invoiced price is different from the price quoted by the sales person); bad debt (for instance, where the customer is simply unable to pay), and delinquent debt (that is, the customer must be contacted to find out why the debt has not been paid). You can now address the problems that have created disputed, bad and delinquent debts.

- **Extending payment terms to customers to avoid offering discounts.** Just as you should be wary of negotiating extended payments terms with your own suppliers without first considering the impact of lost discounts, you should also take care when extending payment terms to your own customers. The problem is one of simple human nature. Once somebody has enjoyed something – in this case, extended terms – they may be more reluctant to relinquish it than one was to gain it in the first place. Put more simply, once payment terms are extended, they are rarely clawed back.

The consequences of these errors can be tremendous. Each year since 1994, my colleagues and I have analysed the balance sheets of more than a thousand of the world's largest publicly traded companies. We have discovered tremendous discrepancies in working capital performance from one company to the next, even among firms within the same industry. Weak performers routinely suffer from excessive receivables, superfluous inventory, an absence of purchasing clout, high operating expenses, and, in worst-case scenarios, insufficient cash to meet day-to-day obligations or strategic objectives. Each year, these firms forfeit billions of dollars in cash flow and profits, depress shareholder returns, and in some cases leave themselves ripe for a takeover.

The best-case solution is to undertake immediate action to improve processes in all three areas that comprise working capital management: revenue management (receivables), supply chain management (inventory), and expenditure management (payables). Because these areas are tightly intertwined, an effort that embraces all three will generate the greatest rewards.

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