BREAKING NEW BOUNDARIES

FIRMS ARE GAINING A MORE ACCURATE VIEW OF THE UNDERLYING HEALTH OF THEIR BUSINESS VIA WORKING CAPITAL PERFORMANCE PROCESSES, SAYS **MALCOLM MACDONALD** OF KPMG.

To sustain shareholder value, a business needs to generate a return equivalent to at least its weighted cost of capital for every pound tied up in working capital. This represents a considerable challenge for managers, even in today's low interest rate environment.

In the majority of businesses, working capital is viewed as a balance sheet item and its management a part of the finance and treasury function – yet all the activities that give rise to working capital take place outside this function. Despite the 'matrix' character of most organisations nowadays, few managers have identified and defined the inter-relationships between those performance criteria – both financial and non-financial – that are necessary to manage working capital effectively. The few exceptions to this are to be found in leading global organisations, which are only just beginning to recognise and address this complex issue.

Historically, business managers expected new best-of-breed enterprise systems to enable more effective management of working capital, usually through standardisation and simplification of supply chain processes. But, as it has turned out, their expectations have not been met, partly because these systems are not pre-configured with working capital matrices and partly because focusing on the supply chain itself only addresses part of the problem.

To address the working capital management issue, we need to look across the entire business value chain (see *Figure 1*) to identify the key activities that impact working capital; to help process owners understand their role in managing working capital; and to identify and measure key performance indicators. The role of the finance function is to co-ordinate this activity and monitor the outcomes.

BENCHMARKING WORKING CAPITAL PERFORMANCE. The first step towards effective management of working capital is the use of benchmarking to assess current practice against that of peer companies operating in both domestic and global markets. Some comparative data may readily be obtained from published sources, while more detailed country level peer group information may require specific research. Typical company level benchmarks are set out in *Table 1*. Of course, benchmarking alone does not provide the

FIGURE 1
THE DRIVERS FOR WORKING CAPITAL SPAN THE COMPLETE VALUE CHAIN.

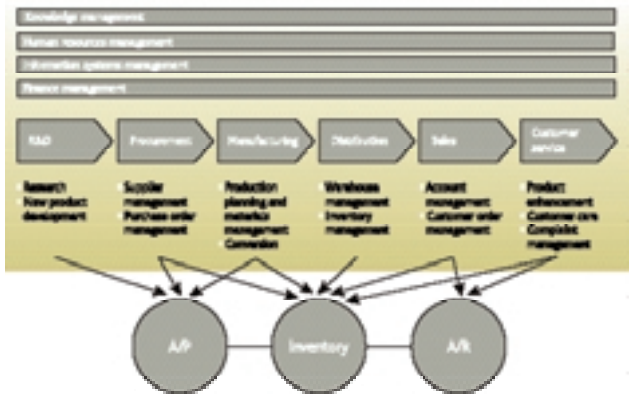

TABLE 1
KEY WORKING CAPITAL INDICATORS.

Company/region level	Average CCE	Average DWC	Average DSO	Average Inv.Turns	Average DPO
XYZ company	14.3%	74	60	6	30
Industry average	7.2%	54.6	34.3	7.6	27.3
Best in class	14.8%	17	24	15	62

Cash conversion efficiency (CCE) = Cashflow from operations/sales

Days of working capital (DWC) = (Receivables + inventory – payables)/sales x 365

Days sales outstanding (DSO) = Average debtors/sales x 365

Average inventory turns = cost of goods sold/average inventory

Days payables outstanding (DPO) = average payables payable/purchase x 365

answers, but it is useful in assessing the potential for improvement and indicating the broad areas to investigate. However, care needs to be taken when interpreting benchmark data: different companies possess a variety of sub-contracted operations and off-balance sheet financing, and they often use different definitions. Even within global organisations, for instance, it is not uncommon to find varying definitions of working capital used in different regions and intercompany balances are often a contentious area.

To identify the underlying drivers of working capital, we need to examine the related business process – order to cash, trade terms management, cash and treasury management, purchase to stock, capital project management and inventory management – and monitor performance at this level. It is beyond the scope of this article to cover all these processes in detail – instead, we will focus on the three areas that impact business at an operational level: order to cash, purchase to stock and inventory management.

ORDER TO CASH PROCESS. The order to cash process covers the receipt and processing of orders, despatch of goods and invoice issuing, debtor management and payment receipt. Key performance metrics cover days sales outstanding, pricing accuracy, order fulfilment, order returns and debtors overdue.

FIGURE 2
COLLABORATIVE PLANNING, FORECASTING AND REPLENISHMENT (CFRP) PROCESS CHAIN.

TABLE 2
ORDER TO CASH PROCESS.

Process level analysis – performance indicators	Target	XYZ co	XYZ co	Average	Strong
Days sales outstanding	20-45	60-49	●		
Pricing accuracy	98%	90%	●		
Order fulfilment OTIF (%)	95%	55%	●		
Order fulfilment in full on day (%)	98%	93%	●		
Order returns (stock credit notes %)	1%	5%	●		
Order returns (cased goods %)	0.5%	3%	●		
Debtors overdue (%)	5%	est 40%	●		

Targets represented agreed achievable improvements based on adopting best practice processes.

Process level timeline analysis and benchmarking should focus on receipt of sales order, processing of sales order, despatch of goods, issue of sales invoice, disputes resolution, debtor monitoring and payment receipt. Typical process level performance indicators are given in *Table 2*.

Typically, best-in-class processes will handle sales orders over the internet/intranet. Sales orders are automated through a company's enterprise resource planning (ERP) systems and relayed to the warehouse electronically with delivery dates and volumes matched to just-in-time production requirements. Sales invoices are issued on the same day as customer purchase with online disputes resolution, line-by-line with automated self-billing.

These new systems replace traditional paper-based documents (such as purchase orders and invoices) with electronic documents speeding up the business cycle and helping to reduce administrative errors. New payment systems, including web-based money and online invoice discounting, are ideal for companies with established trading relationships because they offer easier transaction processing, and, for those using invoice discounting, improved discounting rates. Overall, the billing cycle is reduced, as is the cost of sending invoices, while funds are collected more quickly and debtor days improved.

Additionally, there are a number of specialist sub processes within the order to cash cycle that companies may wish to review – depending on individual circumstances – such as part of a working capital optimisation project, for example, cross border transactions.

PURCHASE TO STOCK. The purchase to stock process covers sourcing, placing of the purchase order, raising of the requisition, goods receipt, receipt of invoice, matching to accounts payable and payment of the supplier. Many businesses have introduced internet supply chain applications whereby standard stock items are replenished automatically according to a predetermined set of business rules. But in companies with a high level of non-stock purchases, customer invoices are often received prior to confirmation of receipt of goods or services. This can result in the application of considerable resource to clear invoice queries. In such cases, rationalisation of the supplier base and use of purchasing cards for non-stock items can significantly reduce costs per transaction.

Typical issues encountered by companies within the purchase to stock process include increasing cost of stock items due to decreasing production run size, and purchasing volumes driving production batch volumes. The latter can lead to higher stocks and eventually to inventory write-offs.

INVENTORY MANAGEMENT. The inventory management process includes sales forecasting, inventory level planning, receipt and processing of sales and purchase orders, replenishment of finished stock, sales order fulfilment and order delivery.

Typical issues that arise in this area range from business complexity (giving rise to a high level of stock keeping units [SKUs]); stocks tied up awaiting repackaging; component standardisation; length of inventory lead times; inaccurate sales forecasts; and problems with run-in and run-outs of new products. Sales forecast accuracy – defined as actual sales within 20% of monthly sales forecast – is often the most critical of the these issues in terms of working capital management.

In practice, many businesses fail to achieve 50% sales forecast accuracy and even leading edge global businesses may struggle to

achieve 70% sales forecast accuracy on a regular basis. In extreme cases, inaccurate sales forecasting has resulted in corporate failure.

In sales, forecasting one thing is certain – no matter how good your forecasting technique, it will never be 100% accurate. It has never been easy to monitor the anticipated requirements of your customers on a real-time basis. Technologies can be used to monitor customer activity but a more recent development is to use collaborative planning, forecasting and replenishment (CPFR) techniques to exchange forecast data between supplier and retailer. (see *Figure 2*).

Collaboration enables all parties to plan more effectively, minimising the need for safety stock. A single shared forecast is continuously revised and converts into definite orders at an agreed time before delivery. This enables suppliers, rather than customers, to initiate orders.

Benefits from improved collaboration include increase in sales growth; a reduction in out-of-stock items; improvement in sales forecast accuracy by as much as 10%; and a reduction inventory levels. Some of the softer benefits include improved data availability and take up of new products.

SOLUTION: THE WORKING CAPITAL PORTAL. Web-enabled treasury systems and in-house treasury portals show the way ahead for working capital management. The time is right for the development of a working capital management layer to the CFO portal, with browser interfaces linking disparate systems and retrieving information on working capital performance. This will help management focus on the many opportunities for optimising working capital in areas such as:

- renegotiation of trade terms, improved credit control, increased full order fulfilment;
- centralisation of non-stock purchases, reduced numbers of suppliers, introduction of e-purchasing cards;
- reduced order to delivery lead times, improved accuracy of sales forecasts, reduced stock of finished goods; and
- improved accuracy of cash forecasts

The recent widespread adoption of internet protocol technology has made it possible to manage and update working capital requirement and cash forecasts in real time. As a result, a few large organisations have incorporated cashflow and working capital metrics into their performance management systems. They are increasingly viewing the management of working capital as a key means of value creation – and this will impact significantly on the capital issue programme of leading businesses.

As analysts gain more understanding of how working capital performance measures reflect the real underlying health of a business, this trend is bound to grow.

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