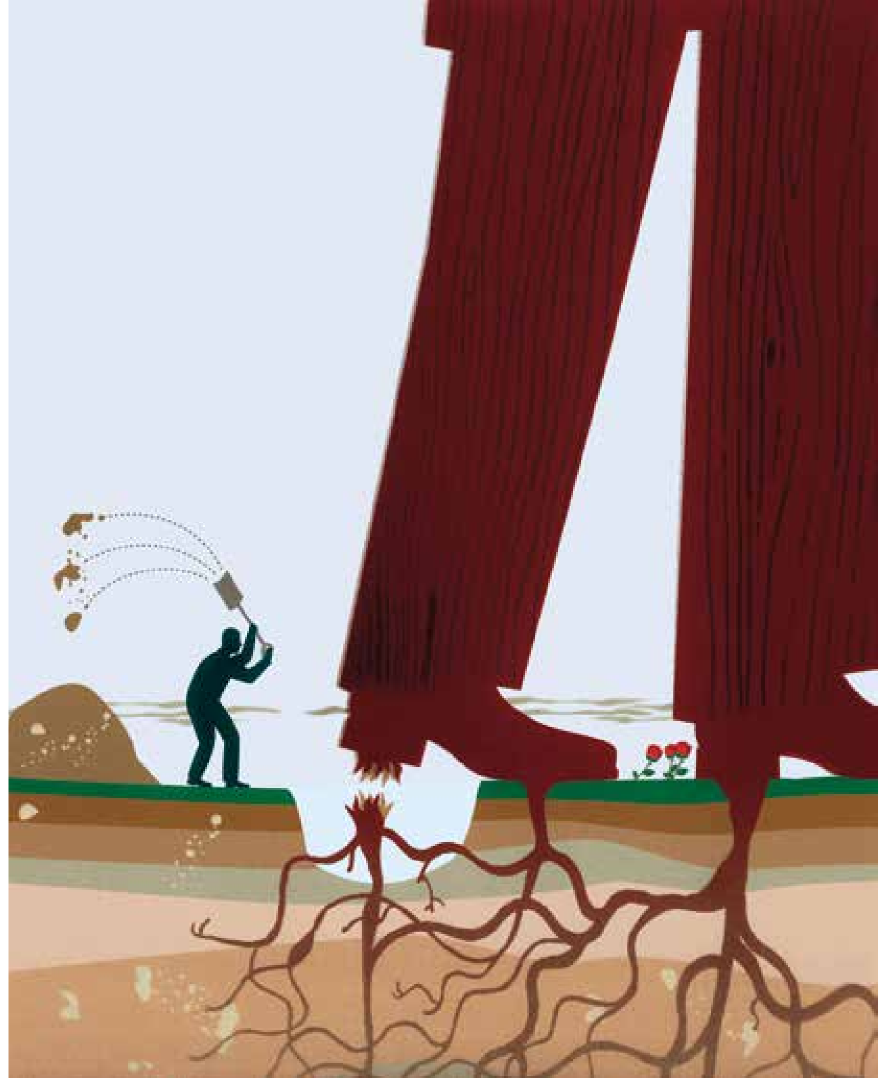

ILLUSTRATION: IMAGE SOURCE

Freeing up funds

WHAT ARE THE KEY CONSIDERATIONS FOR COMPANIES LOOKING TO TRANSFORM THEIR WORKING CAPITAL? JOHN MARDLE EXPLAINS

Many corporates see working capital as an area of finance that they can transform through different approaches, depending upon the types of transaction they undertake.

The major challenge is to establish whether these transactions are accompanied by regulatory considerations, or corporate social responsibility issues, or anything else that might impact the brand or wellbeing of the overall organisation.

For corporates considering a working-capital transformation, the overriding issue is one of strategy. Does the corporate roll out a programme that has a treasury bias or does it instead roll out a generic operational programme that amends processes and procedures within one part of the organisation, before applying it, with adjustments, to other parts of the organisation?

A transformation strategy can involve all three key areas of working capital – namely inventory, payables and receivables – or it might focus on one particular area, with the aim of impacting the other two areas in due course. In addition, capital expenditure is a critical factor that can impact the other three areas because it drains cash.

Communication throughout the organisation, the investment community and, of course, to suppliers and customers is key to ensuring that everyone understands how the transformation is being delivered – whether a strategic or operational approach is being taken and what the timescales and expected outcomes are.

My definition of investment community includes the banks that might lend against such a project or provide the transactional facilities that are needed to achieve the desired goals.

Operational or strategic?

If one was to review the general global footprint of a company's working capital, the following might be regarded as suitable guidelines for a CFO to consider when deciding on a strategic or operational approach:

a) Heavily regulated markets are likely to be in the northern hemisphere, which is dominated by the US and Western European economies. Hence the strategic approach for a utility company, for example, would involve the corporate adopting practices that are very customer-focused when it attempts to streamline collections of receivables. Similarly, where a corporate's business has public-service interfaces, it needs to take into account the impact of government policies. For instance, prompt payment programmes in France, the UK and the US are encouraging corporates to adopt a supplier strategy that entails electronic invoicing through procurement portals.

b) Cultural differences need to be respected on a global basis. Dealing with China in a supplier or customer capacity requires lengthy negotiations at local, regional and government levels. Meanwhile, southern Europe has a long history of paying

invoices 'slowly' when compared with, say, the Nordic countries, where typical payment terms are 14 days.

c) Areas that are likely to be 'at risk' whether it be political (Russia-Ukraine), geographical (Middle East), regulatory, etc, also need to be considered, particularly if the corporate has an expansionist strategy towards improving revenues and profitability.

Practical examples

Let's look at some major corporate working-capital strategies, bearing in mind that a corporate's approach will be driven by the levels of technology that exist in the country in which it operates and those that exist in the countries in which its suppliers and customers operate.

- US conglomerate General Electric has adopted a 'platform' approach in certain areas of its business by using the services of invoice-processing company Tungsten to process supplier invoices. Suppliers are offered the incentive of receiving cash on a timely basis and to have the invoice value 'guaranteed' if they accept a discount structure that triggers payment of agreed amounts at predetermined dates.

- Cisco, in partnership with courier DHL, is developing a type of big data experimentation that it wants other companies to take part in. The companies wish to improve fleet and shipping, inventory management, maintenance and – essentially – all aspects of the supply chain through identification 'tags' that track every part of a product's progress from order through to delivery. This data will reflect every activity, the costs associated with it, and compare it to alternative quotes for the same activity.

- In the UK, broadcaster ITV has instigated a programme that involves a 'platform' called C2FO that focuses on smaller, and possibly less critical, suppliers only, whereby payments are made to these suppliers at a date that they set themselves. If they set a date earlier than the normal terms of payment, then they will have to discount the sum on the invoice – by how much is driven by the value of the invoice.

You will note that the above solutions all fall within the supply chain area and directly impact the payables process. One should not underestimate, however, the indirect impact this has on inventories (both stock and work in progress) by, in some cases, reducing stock levels to a point that causes production lines to become unbalanced. This, in turn, can directly affect customers, who have high expectations of such companies when it comes to delivery and quality, whether they are buying a service or a product.

At this point, I think it is fair to introduce another aspect of complexity within working capital. This is regulation, which can have a particular influence on corporate strategy.

A corporate in the construction sector, especially one that works in heavily regulated areas, will be subject to revenue recognition rules that could be based on the 'percentage of completion' method of accounting. This is where revenues and profits – but not cash – can be generated by reference to the percentage of cost that has been incurred. This obviously means that, if very large-value invoices remain unpaid for considerable periods of time, then a view may be taken that the value is unrecoverable and the corporate will need to adjust revenues and profitability accordingly.

In demand

Let's turn to the receivables aspect of working capital. Here, it is the demand chain (both existing and potential customers) that could impact the decision-making process that a corporate adopts when financing receivables. Factoring (selling the right to collect certain invoices to a third party) and securitisation (of certain parts of the receivables ledger) are well-worn paths to generate cash, but again, the granularity of 'debt' is key. The factoring or securitisation provider's appetite for 'risk' will be critical when they assess the quality of the receivables. The receivables of a corporate are likely to be considered lower risk than those of an SME. If the corporate is based in Greece or Italy, for example, then that might not be the case, however.

Credit management is a key component when risk assessment is undertaken for both receivables and payables. This is why a number of corporates have merged the credit control function into the treasury domain rather than keep it in the transactional area of the finance function. This has the effect of galvanising the linkages between the sales and procurement functions that are necessary to enable the cash conversion cycle to be fully appreciated within an organisation.

An organisation with a cash conversion cycle that embraces projects, products and services will hopefully be able to manage the cash peaks and troughs. This is because projects could have milestone payments and cash receipts that are months apart, whereas products (normally smaller in value) will be sold on a daily basis, and generate receipts and payments on a daily or weekly basis. Meanwhile, services will incur payments when they occur, but receipts for that service may be by direct debit and will be a set amount every month or quarter – in the case of a utility service, for example.

> An organisation with a cash conversion cycle that embraces projects, products and services will hopefully be able to manage the cash peaks and troughs

Conclusion

In conclusion, the area of working capital has developed over the past few years – some might say 'matured' – but few have understood the complexity of the strategy that is now required to deliver a sustainable cash flow. Treasury functions are now in the unique position of being able to 'mesh' strategy with credit management, investment and cash flow. They need to embrace the opportunity to do this sooner rather than later, since credit, inflation and risk are bound to heighten throughout the next few years as the repercussions of the financial crisis continue to play out in the markets.

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