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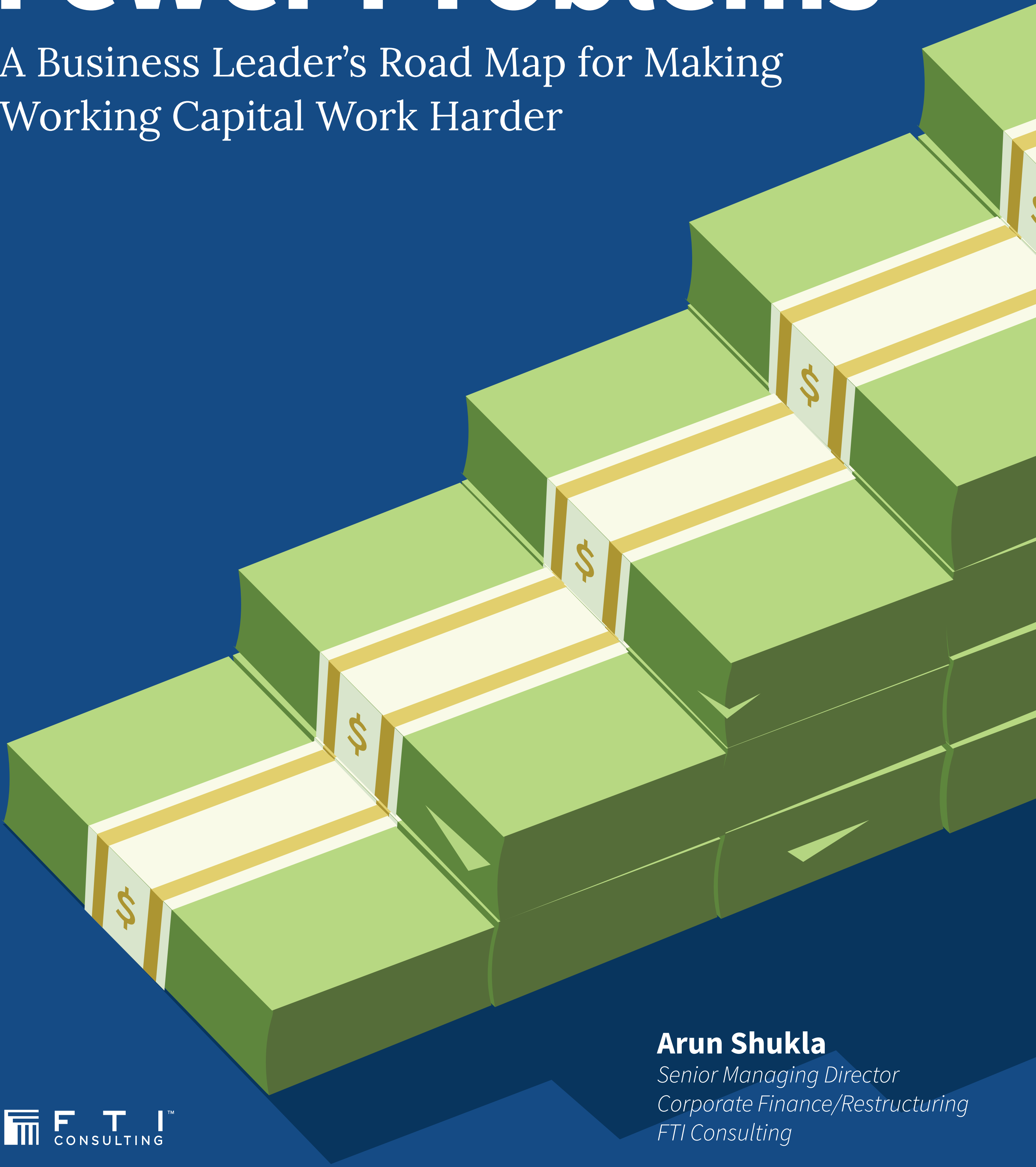
Faster Money, Fewer Problems

A Business Leader's Road Map for Making Working Capital Work Harder



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Working capital has a far-reaching strategic and tactical influence on the functioning of a corporation. Without a tight cash conversion cycle that ensures liquidity, the business is limited in its ability to run day-to-day operations and, in extreme cases, simply to keep running at all. On the other hand, businesses that leave too much cash on the table miss opportunities to fund improvement, profit and growth.

Unfortunately, many organizations take the wrong approach to bettering working capital management. They take action in response to traditional metrics such as days sales outstanding (DSO) and inventory cycle times. But these are blunt and lagging indicators of business health. They shed little light on the business' future trajectory or ways to make sustainable improvements in working capital performance.

Where the Problems Lie

The root causes of poor working capital management are found in the details of core business processes: a lack of transparency in cash flow operations, volatility in cash cycles, unplanned increases in transaction frequencies and nonexistent executive ownership for working capital performance, among others.

We commonly see the following weaknesses across all industries in working capital management:

- **A lack of process perspective**
- **A disconnected financial supply chain**
- **Average-based performance metrics**
- **Disengaged operating units**
- **Clashing incentive systems**

These factors and behaviors can do serious damage to a company's health.

A Lack of Process Perspective

A lack of process perspective inhibits the proper prioritization of working capital improvements. Precious resources are misdirected, and enrichment projects never achieve their goals.

For example, driven by rising feed costs, a large poultry producer raised its prices. Consequently, some key customers requested and were given relaxed payment terms. Other customers reduced their purchases. Still others simply canceled their orders. The net result was that the poultry producer's best customers paid later, extending receivables, and less loyal purchasers bought less or nothing. This reduction in working capital diluted the ability of the producer to get volume discounts for its own purchases, lengthening its procure-to-pay time and making its suppliers unhappy. Worse, the business' unsold inventory grew, tying up further capital and resources. Thus, the unintended consequences of the price increase, flowing from a lack of proper process perspective (how the higher price would impact processes that were coupled to its cash cycle), added up to a working capital disaster.

As with many businesses, this company considered pricing the sole responsibility of sales and failed to consider its effect on procurement and manufacturing.

As a permanent fix to this siloed approach, we recommended an analytics-driven, collaborative process across multiple internal stakeholders.

Then we suggested that the company communicate with its key customers and vendors, explaining the feed price increase as a way for them to manage their own costs in a volatile market with a history of high feed prices.

Indeed, when feed price volatility subsided, the company was able to retain its price increase — and its prime customers — while improving its working capital position.

A Disconnected Financial Supply Chain

Businesses today have a better (if not perfect) understanding of their physical inventories than ever before. Most companies have made large-scale capital investments in supply chain management information technology projects that (if done right) give leaders the real-time or near-real-time information needed to manage inventory and improve physical supply chains. However, many of the benefits of an efficient supply chain can be lost when not integrated with the financial supply chain.

For instance, an iconic brand in seafood processing, with a well-managed global supply chain, was burdened with excessive working capital that was locked in for long periods. This situation was driven by a 16- to 20-week "cold chain" supply cycle in which seafood was caught in remote locations, refrigerated, processed and then shipped to the United States, where it was warehoused. This, in effect, held the company's working capital hostage.

There was little to be improved in the physical flow. However, by contracting with a logistics service provider and transferring the ownership of the seafood to that company as soon as a shipment arrived at the warehouse (enabling the provider to more quickly supply its own customers at lower cost), the processing business was able to reclassify the warehoused seafood as accounts receivable. This enhanced the company's ability to get cash from its credit line, allowing it to use that additional liquidity to take advantage of spot-buying opportunities.

Disconnects between physical and financial supply chains happen because business leaders largely are unaware of the benefits of an integrated approach and the remarkably positive impact such a system can have on working capital. The conversation between business functions too often is limited to optimizing the individual components of procurement, inventory and accounts receivable. Here, the seafood processing company, by transforming inventory to accounts receivable, integrated its physical supply chain with its financial one and freed up previously inaccessible cash to gain greater working capital efficiency.

Average-Based Performance Metrics

Our conversations with business leaders about working capital management reveal that an overwhelming majority rely on average-based metrics. Whether it is days sales outstanding, days payable outstanding (DPO) or days working capital (DWC), organizations typically report these as a single number. This can hide huge variability in performance, and outliers can distort the truth. Operating with average-based metrics, an organization can fall victim to hidden problems or miss opportunities for improvement. Also, the chance to cultivate customers with lower DSOs — and thereby decrease a company's own DWC — may be overlooked.

For instance, a large manufacturer of aluminum extruded sections claimed industry-leading DSO performance.

However, hidden in this averaged metric was a huge variability in performance. Some of the company's large customers had much higher DSOs than the average, locking up precious working capital at a time when every dollar counted. Several smaller customers had lower DSOs. Averaged, it looked great; in detail, not so good. In a period of tight money, the business chose to serve its large customers first. It neglected its smaller but actually better-performing customers and gradually lost them. This cycle continued until the business, fooled by its own metrics, filed for bankruptcy.

Disengaged Operating Units

In many organizations, working capital measures are reported only centrally. Regional and operating business units do not have adequate information about their own working capital positions and, therefore, cannot manage them properly.

In one instance, the chief financial officer of a major consumer pharmaceutical company with multiple operations and brands had no working capital data at the local operating level. He largely ignored the working capital metric while paying attention to revenue and growth. Ultimately, the business lost its operational advantage and was forced to shutter several key plants, including the flagship operation that was synonymous with the company's origin.

It was too late for the business to reopen that plant, but with the business in disarray, the management team decided to create integrated dashboards from various sites and began reporting working capital positions to all business units. This allowed the company to benchmark across regions, resulting in healthy competition between divisions and putting the business on a path of sustainable improvement.

Clashing Incentive Systems

Organizations tend to confine working capital management responsibilities within functions. When that's the case, even incentive systems — especially when they're at odds with one another — can impair working capital management.

For example, a sales department's incentive systems typically promote behaviors that produce higher sales.

However, these sales frequently are secured by a combination of proliferating product lines to increase volume; relentless discounting; and easy, extended payment terms, all of which negatively impact working capital.

Meanwhile, the research and development function, incentivized for introducing novelty features and functionality, may create products with a cornucopia of functions and parts, resulting in complex, unwieldy and expensive sourcing chains that also can waste working capital. Some procurement functions may have their own performance drivers related to cost savings. And operational bonuses driven by production volume may encourage the business unit leaders to focus on larger batch sizes while starving smaller batches, disappointing smaller, but profitable and fast-paying customers.

A financial services corporation, for example, launched several innovative products. Its success depended on infomercials targeting new customers. The company's media buyers, charged with getting the lowest cost in each media market, used the leverage they earned with multiple buys to cut those costs but compromised on airtime slots. That turned out to be a fatal mistake. The infomercials' timing did not match the viewership of the target audience: The products flopped, and the business soon changed hands at distress-level valuation.

To improve working capital efficiency, incentive systems must be informed by a risk analysis within each business function that contributes to components of working capital. This holistic approach ensures that incentive plans are not misaligned, as was the case with the financial services company and its media buyers. Incentive plans should promote behaviors the entire company wants, not simply those that move an individual function's needle.

Making Working Capital Work Harder

Opportunities for better working capital management are there for almost every company, but the clues aren't in the quarterly reports. Business leaders who dig deep can transform working capital management from a finance-only function to a strategic priority across all business units.

The best way to unlock invested capital and increase cash velocity is with an approach that integrates the three key processes of the cash-conversion cycle: order to cash, procure to pay and plan to deliver. We also find it best, typically, to tackle improvements in a three-step process:

Step 1: Conduct a Comprehensive Assessment

Facilitate cross-functional evaluations that promote an understanding of the interplay of working capital activities within and across functions. This assessment phase also can uncover opportunities to reduce product and after-sales service complexity — the low- or no-value-added activities that can cause excessive working capital investment. And this evaluation can identify areas to link parallel processes such as the supply chain and its associated financial transactions.

Focus on the root causes of extreme performance. For instance, profiling DSOs and taking a hard look at extremes can highlight opportunities with specific customers and the sales staff that supports those customers. An in-depth review also can yield lessons from customers with shorter DSOs. Similar circumstances may exist on the DPO spectrum where vendors with low DPOs are penalizing other vendors.

Step 2: Scope and Plan Integrated Working Capital Management Improvement Projects

Prioritize opportunities across the value chain on a Capital-Time-Investment matrix to deliver the highest returns for time and resources invested.

Step 3: Implement Projects and Monitor for Sustainable Results

Manage projects as a portfolio: planning, implementing, monitoring and tracking working capital improvements against a base line. Clearly assign responsibility and accountability for each, and determine how the outcome will be measured. Reporting should be pushed to lower levels throughout the organization. That's where the action is — and that's where improvements can be made.

Finally, supplement process enhancements with incentive programs and reporting analytics that will induce cultural shifts and behavioral changes.

Almost every company has areas where its working capital position can be improved, creating opportunities for investment and reducing borrowing costs. But it takes attention to detail to identify where gaps exist. And it demands that people work together across business units and functions. Orchestrating all that requires senior-level ownership. Very often, the chief financial officer is the person in the best position to sponsor the initiative; he in turn needs business operations to own the working capital measures and help move them in the right direction. An integrated approach to managing working capital benefits everyone in the company and the business itself. ■

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