# Cash Flow Is **Oxygen** *in* *Turbulent* **TIMES**

*By Lisa Higgins and Mary Driscoll*

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## *CFOs Look to Improve Working Capital Management Practices to Combat Liquidity Pressure and the Credit Crunch*

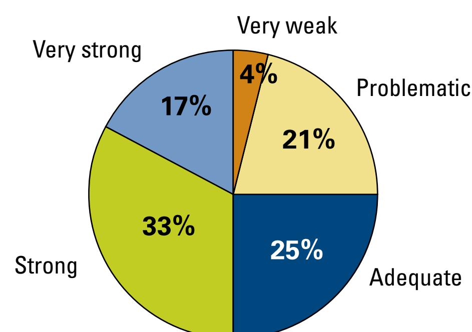
*By Lisa Higgins and Mary Driscoll,* APQC

"You can't pay your bills with profit." Indeed, that old adage now serves to remind CFOs of how very important it is to keep working capital management (WCM) processes in tip-top shape. In these perilous times, when credit is tight and liquidity is dwindling at many large companies around the world, all eyes are on cash flow—the oxygen needed to keep daily operations pumping and, with luck, expansion plans alive and well.

In the United States, access to external financing currently ranges from expensive to unavailable, depending on the strength of a company's balance sheet. But how strong, really, are U.S. corporate balance sheets today? The answer is worrisome.

As 2009 began, industry experts calculated that more than $700 billion in commercial bank loans would need to be reduced, repaid, or rolled over before year-end. With the credit markets still rebuffing many needy borrowers in the first quarter, the assumption is that CFOs will find the task of loan restructuring difficult for at least the first half of the year. With accounts receivable (A/R) balances swelling as customers slow their payments, many firms will be issuing reports to investors and lenders that raise red flags, making borrowing even more difficult.

How would you rate your company's ability to forecast its cash flow?




*Source: APQC December 2008 online survey*

Looking at the public debt picture, Standard & Poor's Corp. reports that nearly two out of three non-financial companies began the year with below-investment-grade ratings. The credit rating agency suggests that, before 2009 ends, U.S. defaults on high-yield bonds will reach a level not seen since the Great Depression.

With suppliers demanding accelerated payment—or even cash up front—and customers slowing their payments, more than a few CFOs have been caught off-guard. Many now admit that their cash flow forecasting capabilities are long overdue for overhaul, or that they don't know where, exactly, to start repairing their working capital management processes to facilitate the movement of cash from inventory investments to customer orders and on to collected invoices.

### CASH RUNWAYS FOR ALL?

Clearly, cash reigns supreme these days—a fact made clear to the CEOs and CFOs of big names like Kodak and Textron and other companies whose investors have transformed earnings meetings into cash-flow forecasting sessions (or worse). Textron CFO Ted French left the company on Feb. 9, 2009, four days after investors responded unfavorably to the manufacturer's decision to draw down all of its $3 billion in bank credit lines.

Not so long ago, discussions about "cash runways" were reserved for start-ups and companies barreling headlong into bankruptcy. Today, a surprising number of firms are quietly monitoring cash runways. Why? Because they need to answer the question, "If everything goes badly, how long before our cash runs out and we can no longer support day-to-day operations?"

Addressing cash concerns requires a sharp focus on the corporate treasury function and on working capital management practices in particular. Ironically, companies tend to focus on their ability to generate cash from operations only *after* they hear the thud of a credit crunch and realize that access to third-party funding for daily operations has evaporated. What remedies are CFOs reaching for this time around?

Given the pressure under which working capital managers are operating today, few want to publicly discuss their response to the credit crisis and recession. However, glimpses into their approaches through their external partners reveal that the practices they are currently using to liberate cash locked up in receivables, payables, and inventory differ somewhat from the tactics they relied on in past downturns.

For example, many companies are shunning short-term A/R and accounts payable (A/P) initiatives designed to free up cash by hammering customers to pay earlier or forcing suppliers to wait longer for their money in favor of more thoughtful alternatives.

"I think there is a greater awareness about the importance of looking after supply chain partners," reports Treasury Alliance Group Partner Peter Pinfield, who notes that many companies have moved from adversarial negotiations with suppliers to more collaborative partnership arrangements in recent years. "They don't want to upset that because they realize that the efficiency of their supply chains depends on them looking after their suppliers."

The severity and pervasiveness of the current downturn, as well as advancements in just-in-time inventory processes, pose new challenges to traditional WCM approaches. Lean inventories free up cash, but they can make some companies vulnerable to price spikes. Additionally, the loss of a small-but-crucial supplier can greatly decelerate the just-in-time processes required to maintain lean inventories.

These challenges influence how treasurers, corporate finance executives, and working capital managers deploy traditional tactics for reducing the amount of cash tied up in working capital. Leading companies look at the current economic predicament and see an opportunity to implement sustainable best practices and improve decision making around the generation and deployment of operating cash.

## INVISIBLE IN BOOMS, CRUCIAL IN BUSTS

Improving the management of working capital is straightforward in theory, but can be difficult to execute. Increasing a company's cash advantage simply requires adjusting the relationship between its short-term assets (cash, A/R, and inventories) and short-term liabilities (A/P and short-term loan payments). According to APQC research, top-performing Fortune Global 500 companies (those with median revenues of $30.7 billion) enjoy a cash advantage of $2.7 billion over lower-performing companies of the same size—an advantage achieved primarily through better working capital management practices.

The majority of tactics used to squeeze cash from A/R, A/P, and inventory management processes are well-established. However, successful WCM initiatives require executive support and active participation from sales and operations. A silver lining to the current economic crisis, if one exists, is the growing clout enjoyed by corporate treasury and working capital management.

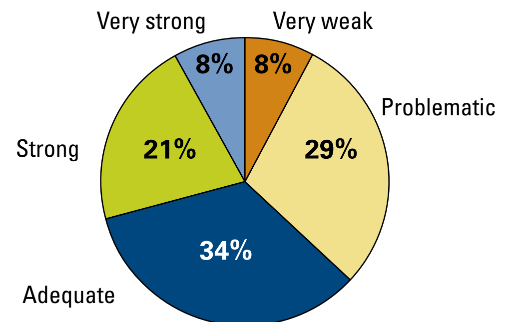
While preparing a presentation on the corporate treasurer's changing role for the Association for Financial Professionals' (AFP) upcoming conference, Craig Martin, a director of the nonprofit AFP and the leader of its treasury subgroup, spoke with another practitioner who remarked that, although treasury's role has not changed, "I think we're just much more visible."

Rather than spending most of their time with the CFO, treasurers are sought out by the CEO, the head of the audit committee, and internal and external auditors. "It's not really a matter so much of new and

emerging practices," Martin notes. "It's more that everybody is now paying attention to what they used to pay attention to: working capital. Everybody is really looking at cash flow forecasting."

Not all companies are executing cash flow forecasts and important steps to improve working capital as effectively as they would like to. An APQC December 2008 online survey of treasury executives found that 50 percent of respondents identify their cash flow forecasting capabilities as "adequate," "problematic," or "very weak." Only 29 percent of respondents categorize their companies' ability to optimize inventory levels as "strong" or better, whereas the remaining 71 percent describe their companies' capabilities in this area as "adequate" or worse.

How would you rate your company's ability to optimize inventory levels?




*Source: APQC December 2008 online survey*

*Note: Optimal inventory is defined as keeping only the amount of inventory in hand necessary to meet customer needs in a timely fashion and maintain customer satisfaction rankings.*

These results are troubling because the majority of potential long-term working capital gains reside in inventory optimization efforts. Improvements to A/R and A/P are necessary and can yield quick results, but these efforts need to be managed carefully to sustain longer-term working capital improvements. John Matson, a KPMG LLP principal who works with aerospace and diversified industrials companies, recently spoke with a CFO who described an initiative that relied on "brute force" to reduce days sales outstanding (DSO) by four days.

"You're seeing a short-term reaction where people are running toward receivables and payables because those are the areas companies can influence in the short term," Matson notes. "The companies that really get it, however, are following these receivables and payables efforts by really going after inventory." He estimates that companies introducing systemic, long-term WCM enhancements can improve working capital performance by 25 percent to 30 percent, whereas short-term, brute-force methods tend to result in improvements closer to 10 percent.

## TAKING ACTION, ADDRESSING OBSTACLES

Spurred by expensive and/or limited access to external financing, many companies are undertaking working capital management initiatives. Nearly two-thirds of respondents to APQC's online survey indicate that they are currently conducting or plan to conduct WCM process improvement initiatives. Some of these process improvement efforts focus on a specific component of working capital, such as receivables, inventory management, or incentive compensation links. Chemicals-manufacturer Ashland, for example, conducted an initiative that linked 40 percent of managers' variable pay to working capital levels. This change helped reduce working capital by $260 million, or roughly 3 percent of sales, in 2008.[1]

Other WCM process improvement initiatives are more sweeping. Matson recently helped a company create a metrics hierarchy that translated working capital management into specific A/R, A/P, and inventory measures and then translated those measures into operational drivers. The metrics hierarchy has been instrumental in educating people throughout the organization about WCM. An operations vice president whose division received 100 supplier shipments early one month used the metrics hierarchy to understand that the early shipments cost the company more than $8 million in working capital.

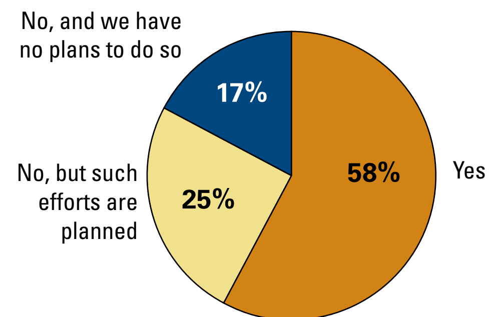
"A major part of many of these efforts includes re-educating everybody in the organization on the time value of money," notes Ernie Humphrey, director of AFP's treasury services subgroup. "It's a matter of re-education and tightening the reins to make sure people understand a true cost of financing sales." An ongoing WCM improvement initiative at World Fuel Services, a downstream provider of fuel

[1] Vincent Ryan. "All Eyes on Treasury." *CFO Magazine*: Jan. 1, 2009.

products and related services with annual sales of $13 billion, began with a three-month re-education effort that helped all employees better understand the impact of their activities on working capital.[2]

The following sections highlight specific tactics that treasury professionals can use to free up cash in A/R, A/P, and inventory.

Has your company undertaken process improvement exercises focused on its working capital management processes and practices?




*Source: APQC December 2008 online survey*

*Account Receivables*

Foresight, education, communications, and customer segmentation are the primary levers that treasury can pull to extract more cash from receivables. During turbulent times, knowing which customers pose the greatest risk to the company requires an ongoing analysis of customers' financial health and consistent communications among the A/R function, treasury, sales, and customers.

Cardinal Health CFO Jeffrey Henderson adjusted to the recession late last year by replacing his review of a monthly written A/R report with twice-weekly meetings attended by the corporate treasurer, business-segment CFOs, credit and collections professionals, and the head of the company's financial services group. Henderson made the adjustment not because hospitals, doctors' offices, and other customers were falling behind in payments, but because he wanted to be prepared in case economic conditions deteriorated and problems started to occur.[3]

Companies can better identify potential leaks by segmenting customers and then treating them differently based on their value to the company and their current financial health. According to treasury consultants, too many companies still treat most or all customers equally. Doing so prevents companies from assigning their most effective A/R collections professionals to accounts that need the most attention.

Understanding the financial health of key customers enables treasury to help sales proactively adjust to changing trade credit risk profiles and opportunities. A healthier flow of financial intelligence to corporate decision makers can help liberate cash from A/R (as well as from A/P and inventories). Working capital managers who monitor the credit environment and customers' financial health can share those insights with sales. If a major customer is in great shape, the sales team can focus on selling more to that customer—and, perhaps, offering more attractive trade credit terms as an inducement for earlier-than-usual cash payment.

*To release cash from A/R during tough times:*

- establish or review a formal A/R program, ideally one that uses electronic collections;
- benchmark and track the underlying processes in the finance function that might be swelling DSO unnecessarily (for example, monitor the time it takes to create and send error-free invoices or the time required to send out payment reminder notices);
- segment customers based on their value (and risk) to the company, and use that segmentation to guide communications with key customers and/or at-risk customers;
- use predictive analyses and analytical tools to identify slow payers;

[2] Vincent Ryan. "All Eyes on Treasury." *CFO Magazine*: Jan. 1, 2009.
[3] Richard Gamble and Russ Banham. "CFOs to Watch: Steering Through Troubled Times." *Treasury & Risk:* December 2008.

- leverage financial analytics and tools to monitor the financial health of key customers, and use that information to adjust sales activities;
- consider offering discounts for early payment; and
- monitor payments for unauthorized deductions.

***Account Payables***

The same precision with which companies monitor customers' financial health can be applied to analyzing the health of key suppliers and vendors. "Some companies take their credit people and turn them around," reports Treasury Information Services Principal Kenneth Parkinson. "The same analytical tools that credit managers use on customers can be applied to vendors. In some cases, you need to look at your vendors to say, 'If that one goes under, we are in trouble!'"

In a previous role working in a large manufacturer's corporate treasury function, Parkinson and his team realized that a small supplier made a vital component in the radar-tracking system produced by the company. The system could not be built without this component. Parkinson's company wired funds to the struggling supplier's account and maintained regular communications with the firm to monitor its financial well-being. "We knew that, in the event of any type of downturn, they were gone," he recalls. "And we in corporate treasury put pressure on the division [that manufactured the system] by saying, 'Find another source for the component.'"

Treasury experts caution against automatically extending payment cycles without considering the impact on suppliers. They also emphasize the importance of communicating with vendors' customer communications staffs and, if possible, taking advantage of discounts offered by vendors for early payment.

*To release cash from A/P during tough times:*

- understand the impact to suppliers before extending payment cycles;
- consider requesting pre-set terms (if they do not exist) and negotiating;
- monitor the financial health of important suppliers, including smaller companies that provide crucial products or services;
- use financial analysis of suppliers' health to drive changes in procurement practices (e.g., finding new suppliers); and
- consider "care-taking" important, at-risk suppliers by extending credit and/or providing more favorable payment terms.

***Inventory Management***

Companies that monitor the financial health of suppliers and customers can apply that information to their inventory management processes. By incorporating such insights into demand forecasts, companies gain a clearer picture of how much—and what kind of—inventory they need to keep on hand.

Although just-in-time inventory processes have made significant headway in the past decade and many businesses have steadily lowered inventories in recent months, "there is still a lot of padding out there," Matson notes.

The pharmaceutical industry, among others, appears ripe for inventory improvements. An October 2008 Ernst & Young analysis of the 16 largest U.S. and European drug-makers finds that most of these companies have the potential to release the equivalent of 3 percent to 7 percent of sales—roughly $17 billion to $35 billion—from working capital. Inventory performance improvement could account for $5 billion to $10 billion of those gains, according to the study.

Last year, drug-maker Bristol-Myers Squibb began reviewing product planning and management to reduce inventory as part of a larger working capital initiative. A company spokesman reasoned that there was no need to continue to offer a product with seven different dosages if 90 percent of demand centered on only two of the dosages.[4]

Making these types of decisions requires information, which typically resides in ERP systems, and a tool to extract it. Ernst & Young emphasizes that inventory improvements can be obtained by "establishing leading demand forecasting processes" and "building greater linkage and closer coordination across the entire supply chain."

*To release cash from inventory during tough times:*

- monitor the financial health of key suppliers and customers;
- use financial analytics and tools to monitor current and future sales and demand trends, and then adjust inventories accordingly; and
- maintain a "just-in-time" balance between being too lean, which can leave the organization vulnerable to price increases, and being too fat, which can lead to higher warehousing costs.

### Avoiding Obstacles

The good news is that turbulent economic times have equipped corporate treasuries with renewed authority, often in the form of CEO or board-level mandates to free cash from working capital. The bad news is that the economic crisis also creates obstacles that can impede working capital management initiatives. Here are three impediments that often require attention.

**Job Cuts in Treasury:** "I was just at a cash management conference, and about one-third of the attendees were out of jobs and networking," notes Treasury Information Services Principal Kenneth Parkinson. "One attendee recalled how she worked for a drug company where three [treasury] people with something like 20 years experience each had just been given the kinds of severance offers you can't refuse to accept." The majority of treasury professionals left in the pharmaceutical company possess less than two years of experience.

**Loss of Expertise:** Layoffs that cut indiscriminately across the finance department can also impact the wrong people from a working capital management perspective. "Some of your best collections and receivables people may be hidden in the organizational structure," notes Deloitte Consulting Principal Sam Silvers. "You have to make sure you hold on to your best collections people."

**Processes Originate Elsewhere:** Although most tactics to improve working capital are not new, they can be difficult to orchestrate, largely because A/R, A/P, and inventory management processes reside in discrete silos. Even when these functions are centralized, changing them requires treasury professionals to reach out into the business and encourage operational colleagues to change.

## CASH FLOW FORECASTING

Many of the tactics designed to free money from A/R, A/P, and inventories can also help boost the accuracy of cash flow forecasting—the process of continuously tracking all cash dispersals and all cash collections.

For companies that need to extract the largest amounts of cash from working capital, cash flow forecasting may be the most pressing, and challenging, issue. "Cash flow forecasting generally is an area where we see a lack of discipline," reports Matson. He points to a late-2008 survey of 566 U.S. and European finance executives that his firm conducted with CFO Research Services in which only 14 percent of respondents identify their cash flow forecasts as accurate.

Companies that create accurate cash flow forecasts maintain strong controls around their procurement cycles as well as visibility into their sales pipelines in terms of accurate demand forecasting. Both capabilities require information and tools to extract and deliver the information.

Companies that develop useful cash flow forecasts also tend to employ treasury professionals who know when to challenge the data they collect from other parts of the organization. "Some working capital managers collect data and call it a forecast without adding any value to it," notes Parkinson. "They need to have the experience to say, 'Hey, this doesn't look right,' to the source of the data."

[4]Ernst & Young Global Pharmaceutical Center. "Big pharma has potential to free up US $35 billion in working capital." *Ernst & Young:* October, 2008.

Effective cash flow forecasts, like other working capital process improvements, require access to information scattered throughout the organization. And that access requires software. "Sometimes you have to spend money to gain visibility so you can get access to more cash," notes AFP's Martin. "So, companies are implementing the tools that are out there."

## A RARE OPPORTUNITY

Spending money to save money may not seem like the most appealing internal pitch to make these days. The irony is that treasury may have more clout than ever to make its case and bring about the sorts of working capital process improvement initiatives that would have fallen on deaf ears in recent years.

"If you're looking to re-orient your cash-collection mechanism or improve your overall cash flow management," Parkinson asserts, "this is the time to do it because you're likely to be able to beat down any barriers."

Whether the goal involves launching large-scale initiatives—such as re-educating the entire company on how working capital functions and instituting compensation links to working capital measures—or pursuing discreet projects to address receivables, payables, or inventories, treasury has a valuable opportunity. It can assume greater control of the management of working capital while providing the company with greater visibility—and more cash—during a turbulent time.

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## ABOUT APQC

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