



Back to basics

Capital in the credit crunch is expensive and hard to find – which means cash management is moving up the finance function agenda. **Audrey Besson** and **Richard Young** recommend a return to basics in corporate funding strategy.

A year after striking the financial services industry, the credit crunch is reaching the corporate world. When companies such as Marks & Spencer, John Lewis Partnership and Taylor Wimpey send out signals that they're feeling the squeeze, it's fair to say that every business should be mindful of its funding requirements in the current environment.

But it's not just lack of liquidity in the money markets. With an economic downturn looming, companies are starting to look at cashflow with a newly critical eye, hoping to avoid the nightmare of falling revenues unmatched by lower cuts. And well they might: at the end of 2007, the top 1,000 European companies had €865 billion of cash unnecessarily tied up

in working capital, according to the REL/ CFO Europe 2008 Working Capital Survey.

If, at this point, there's still any complacency in your approach to cash – working capital management is hardly rocket science, after all – then consider this: REL has discovered that in 2007 the average days of working capital (DWC) situation actually got worse, rising to 47.3 days from 46.8 days in 2006. Although European businesses improved their days payable outstanding (DPO), this was offset by a slight deterioration in days sales outstanding (DSO) and a significant increase in days inventory outstanding (DIO).

'This marked change in performance was a sign that the impact of global credit turmoil

was beginning to be felt by European companies at the end of 2007,' says Brian Shanahan, Project Director at REL. 'As these effects become more acute, more companies will be keen to hold on to their cash for longer. While this will give them an initial DWC performance increase, over the longer term the benefits will be cancelled out by their own customers increasing the time that they take to pay them. This trend is expected to get worse during 2008 before any sign of improvement.'

That's going to ratchet up the pressure on every organisation's finance function. So it can't hurt to run a refresher course in cash management for your own finance team – and for the non-financial managers in your business.

Visibility of cash

Cash monitoring and forecasting don't sound like the most strategic or interesting parts of the CFO's role – in fact, they're usually delegated. But given lack of liquidity and looming economic difficulties right now, any CFO will be expected to be aware of their cash position, at any point in time.

Whereas, in the past, net income forecasting was sufficient, today many investors require companies to produce a rolling 12-month cashflow outlook. That means having the right tools in place to be able to track data throughout the 'financial supply chain' in your own organisation and having consistent management information.

According to the late George Moore, founder member of the Society of Turnaround Professionals, that cash forecast can be life or death for a business during a downturn. 'A realistic and well-researched cashflow forecast 13 weeks out will pick up sudden increases in sales and costs,' he told *Real Finance* magazine in 2006. 'It's pretty straightforward to work in the payments side – the salaries, taxes, leases and supplier invoices. All you have to do then is estimate the collections you're sure about and you'll see straight away what you've got to do in terms of sales and improved collections.'

Outgoings are also vital: activity based costing, for example, can highlight overheads that could be eliminated and unprofitable lines that should be the first on the chopping block.

One aspect of working capital that's often obscured from management is disputed invoices. Struggling clients will be managing their own working capital, and that can mean late payments or haggling; more complex disputes can put large sums into the dreaded '120+ days' column. But if disputes are quickly raised to management then director level – rather than festering in the bottom drawer of an account executive – fast decisions can be made about potential refunds, starting negotiations with client decision-makers or taking legal action.

Companies are increasingly adopting integrated systems to automate cash-related processes. The Royal Bank of Scotland, for example, has just signed a multi-year contract with Accountis for an e-invoicing service to provide operational efficiencies and quicker payments, reduced days sales outstanding and reduced capital requirements. And

according to recent research from working capital consultancy Demica, most banks now offer corporate clients supply chain financing (SCF) solutions to optimise the scarce credit that is still available.

Larger organisations can take this a stage further with centralised shared services and outsourcing. Again, the credit crunch and economic downturn are very persuasive arguments for a general tune-up in finance

function efficiency – and creating visibility in cashflow should be a prime driver.

Customer-to-cash

Cash management is more than just great systems and transparency in the finance function. From the moment a purchase order is taken to the payment of the final invoice, there are plenty of opportunities to influence the working capital cycle. Proactive cash management starts with the right credit

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Common-sense cash



We've unearthed some sage advice from the late George Moore, founder of the Society of Turnaround Professionals and something of a guru for those interested in helping companies out of a fix. Depending on the depth of the downturn and the extent to which your business is starved of cash, these tips might find a place in your bottom drawer:

- Negotiate with suppliers. Will they accept cash up front for new orders and an orderly, but gradual, pay-down of accumulated debt?
- Analyse your optimum return on capital. If your cost of borrowing is high, for example, see if you can settle debts early and instead of paying interest, use the cashflow to secure early payment discounts from suppliers.
- Beware invoice discounting. It's relatively expensive and you can run into problems if sales dip. So you need

to understand your business cycle really well. Borrowing against physical assets is smarter.

- Consolidate debt into a long-term bank loan and arrange a suitable overdraft for day-to-day fluctuations. Shareholders will see more value when you gradually chip away at the bulk of the debt.
- Look for disaggregation opportunities. Often businesses own assets that'd be more valuable under a different structure. For example, sell property to a company commonly owned by the shareholders, then lease it back – that ring-fences the value for the owners.
- Sweat your assets. Let's say you have a manufacturing facility working eight shifts a week. Why not spin it out as a new business and find customers for the other shifts?

A working capital glossary



DSO – days sales outstanding.

Take year-end trade receivables, net of allowance for doubtful accounts (plus financial receivables) and divide by net sales per day. Poor DSO (a higher number – the European average excluding car-makers is 55) may signal weakness in the customer-to-cash processes.

DIO – days inventory outstanding.

Take year-end inventories and divide by sales per day. Poor DIO (higher than the non-automotive European average of 38) suggests weakness in the forecast-to-fulfillment processes such as supply chain and manufacturing.

DPO – days payable outstanding.

Take year-end trade payables, divided by sales per day. Higher DPO is good (the non-automotive European average is 45.8) as it increases cash on hand. Low DPO is a sign of weakness in areas like supplier management, procurement, and payables.

DWC – days working capital.

Calculate from year-end net working capital (trade receivables, plus inventory, minus accounts payable) divided by sales per day.

Thanks to REL for offering their definitions in the working capital lexicon.

decisions. As the sub-prime mortgage crisis illustrates, inappropriate underwriting rules can seriously damage business viability. So the credit policy should be clearly defined – to include your company's credit criteria, standard payment terms and detailed reporting requirements – and signed off by the board.

Ensuring invoices are accurate, timely and payment standards are clearly stated is key. Providing user-friendly payment facilities – such as online payments or direct debit options – will also help. Offering a discount for prompt or early

payment is a great way of improving cashflow. And, if you need to tighten the belt another notch, you always have the option of re-setting the credit terms offered to customers.

Your collection processes, routines and controls are critical to cash performance. Again, many companies have the best intentions – but metrics such as DSO, essential in monitoring working capital, can end up being overlooked. With an uncertain economic outlook, it makes sense to conduct a daily review of the receivables report – it's a great way to spot gradual tightening in specific sectors or problems emerging at key clients.

It's also important to make stars out of the credit control team. They usually toil away in obscurity, but they're the engineers in the boiler-room of working capital. If they're not already, turn them into 'account managers' with a remit to help you understand your customers better and create relationships that could make the difference between getting paid on time or a few days late. Staff incentives can also have a significant impact – and not just in the risk or credit control teams. Salespeople should understand that a sale is not complete until the payment has been received. So link remuneration to the appropriate collection metrics.

Finally, if your company's standard terms and conditions include penalty interest on late payments, now could be the time to enforce them. That sort of policy tightening requires a degree of diplomacy. But as part of a broader approach to contract enforcement that includes, say, early settlement discounts, it can be done.

Procure-to-pay

Supplier management can also play a critical role in the finance supply chain – but it's worth bearing in mind that cash management in the payables function need not mean late payments or chiseling hard-up suppliers for more favourable terms.

Managing your payments against supplier terms is job one – and it's another area where companies don't often look at the details in each and every case. So make sure suppliers are paid on the exact due date – except where it makes sense to take advantage of pre-agreed discounts for early payments. Accurate cash forecasting will help you decide whether less cash out now is better than slightly more later on.



When selecting a new supplier, the procurement team should take into account any flexibility around payment terms. That means a management accountant will need to brief buyers and line managers on where they ought to be negotiating, rather than simply looking at lowest price.

It's also a good time to strengthen purchasing policies. At the macro level, are there opportunities to consolidate suppliers? Approval processes for expenditure should be strictly adhered to, of course. You should also consider lowering the value threshold for CFO sign off – or automating the approvals process to ensure senior managers are held accountable.

Good inventory management can also improve working capital performance. As with other aspects of cash management, transparency is the key. The finance function should use the cash forecast to crunch the numbers in a way that plots a path between minimal stock, a satisfactory supply chain and maximum benefit from procurement terms. And does that offshore manufacturing deal still look as good when you factor in the six weeks your stock will be sitting on a boat?

Alternative funding

Minimising working capital, having efficient processes and developing a clear, accurate forecast of cash are all must-haves, especially during a downturn. But whether you need to boost working capital to cover a sales slow-down or – more importantly – invest for growth ahead of an upturn, additional borrowing could still be on the agenda.

Assuming the bank is less keen to lend now than it might have been 18 months ago, or is imposing tougher covenants or higher rates, you'll need to look at alternative sources of cash.



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cycle, although the receivables will have to be sold at a discount – and the fees can mount up. It's certainly a growing market: the invoice finance sector grew by 460% between 1995 and 2005; by 2006, over £19 billion of receivables were in play with finance firms in the UK alone.

Terms will differ between factoring companies, and over recent years 'confidential invoice discounting' (which hides the arrangement from your customers) has risen in popularity. So it's worth shopping around. And check whether your bank would accept a loan using account receivables as collateral – their fees will typically be cheaper.

Selling non-core assets is another option for a larger cash injection. Lloyds TSB raised funds through the sale of its Abbey Life business to Deutsche Bank in July, for example. And consider property sales. Last year HSBC did a sale-and-leaseback deal on its global headquarters that raised £1.1 billion in cash.

Then we get to the really tricky areas. In today's market, delaying investments is probably already on your agenda. Capital expenditure aimed for growth might not be a priority right now, with senior management preferring to focus on cash management. But hasty cuts – in areas such as marketing, for example – could have a detrimental affect on medium-term cashflow. Again, the management team needs to be able to see how things will play out in the 12-month rolling cash forecast before making decisions that could kill the company just as an economic upturn rolls in.

Overall, cash management requires companies to have the right tools available, ensure the basics are in place and to think creatively when it comes to alternative sources of funding. This isn't about 'teaching grandmother to suck eggs' – or, indeed, a CFO to learn the importance of DSO. Rather, it's an opportunity to look again at systems and processes right through the organisation – in different departments and at every level – to ensure that best practice in cash management is in place. ■

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Richard Young

Richard Young spent eight years writing for and about finance directors, first as acting editor of *Financial Director*, then as editor and publishing director of *Real Finance*. Since 2006 he's been freelance, working with organisations such as KPMG, the European Patent Office, Microsoft and CIMA, as well as a number of business and accountancy magazines. Young also runs courses on better business writing.



While cash pooling – netting off your cash positions across different parts of the business to minimise its overall debt position or maximise interest received – is already a mature product, not all corporations have adopted it. But it can be a powerful tool for efficient cash management and allows businesses to strengthen controls, maximise cash return, decrease borrowing needs and get easier access to funds. At a time where European initiatives like SEPA are gaining credibility, cross-border cash pooling appears to be an obvious solution.

Cash pooling is a no-brainer whatever the credit climate. But there are other options that only become attractive during these more uncertain credit and trading conditions.

Factoring and invoice discounting, for example, will help accelerate the cash