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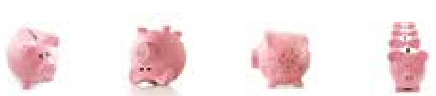
Make your working capital work for you

Strategies for optimizing your cash management



Part of the Deloitte working capital series

The Deloitte working capital series

Strategies for optimizing your accounts receivable

Strategies for optimizing your accounts payable

Cash management

Strategies for optimizing your inventory

In many industries, both debt and equity funding remain difficult to access. This creates a serious challenge for companies that require cash to remain competitive, maintain financial flexibility and pursue potential growth opportunities. While market trends change and customer preferences shift, one thing is immutable: cash remains king. Companies primarily focused on accessing that financing externally, however, may be overlooking a large, hidden source of capital: their own balance sheets.

To be sure, accessing that cash requires organization-wide financial discipline and a clear working capital optimization strategy. On some level, most companies understand this. However, understanding is not the same as actively implementing strategies for improving your cash flow. If you don’t have a formal working capital strategy, have not adopted appropriate drivers and metrics, or simply have not communicated clear policies across the organization, you may be missing out on opportunities to hit your free-cash targets, reduce costs, increase shareholder returns and fund growth.

While there are numerous ways to free up working capital, this series focuses on four core strategies: accounts receivable, accounts payable, inventory and cash management. This third installment looks at cash management.

Building a cash management culture

Accounts receivable, accounts payable and inventory are all components of working capital that companies can streamline to access cash trapped on their balance sheets. When approached holistically, however, proper management of your accounts receivable, accounts payable and inventory all fall under the umbrella of effective cash management.

To improve any of these levers, companies must create a cash management culture. For senior management, this means going beyond prioritizing cash flows in an effort to free up cash. It means encouraging financial and cash flow discipline in both good and more difficult economic times.

Depending on a company's goals, financial discipline can translate into different initiatives. These may include the adoption of more prudent investing criteria or a leaner cost structure. Either way, a focus on financial discipline including integrated financial and cash flow forecasting generally allows companies to strengthen their balance sheet improve financial stability and can lead to greater profitability. As a result, your company gains the control and flexibility it needs to achieve a competitive edge.

A crash course in culture creation

As with any cultural shift, embedding a cash management culture within your organization requires management buy-in. Companies that succeed at this effort typically define their objectives up front, assign responsibility to people across the organization and then track progress using monthly cash flow metrics.

To encourage adoption, it's imperative to establish, communicate and implement standard policies across the organization. Cash management policies should focus on budgeting, forecasting and financing and indicate how to handle day-to-day activities such as collections, procurement/ordering and payment.

Keep in mind, too, that cash flow management is not just a finance issue; it's an operational issue. All departments – from sales and marketing, procurement and production to finance and treasury – must coordinate for optimal results. To drive this point, many leading companies actually link staff compensation to achieving specific cash flow targets.

Adopting best practices

In the accounts receivable, accounts payable and inventory papers in this series, we discuss many cash management best practices, including the centralization of accounts receivable and accounts payable processing through a centre of excellence that enforces common standards; the automation of cash management processes; and the adoption of key performance indicators (KPIs).

Other best practices include:

1. Using technology to shorten the cash conversion cycle

By delivering invoices electronically rather than via mail, you can speed up billing and collection. By implementing a vendor portal, you can give vendors electronic access to invoices, enable electronic payments and reduce the time it takes to resolve disputes. These solutions also tend to provide organizations with timely and robust reporting that can help you take proactive steps to resolve delinquent accounts or take advantage of supplier discounts.

2. Optimizing your financial functions

There are a wide range of optimization techniques you can adopt to improve cash management. For instance, effective accounts receivable practices include reducing error rates on invoices and adopting a regular schedule to follow up on collections. Effective accounts payable practices include negotiating favourable terms and rebates with suppliers, issuing purchase orders for new orders, using available volume rebates and trade spend initiatives, and periodically benchmarking vendor contracts against industry standards.

There are also best practices that companies can adopt from an inventory perspective. For instance, it makes sense to periodically analyze accounts and SKU profitability to identify slow-moving, obsolete and non-profitable inventory so you can reduce inventory levels. It's also important to consider the cash flow implications of changing your supply chain strategy. Companies that source product from low-cost countries, for example, might enjoy lower per unit costs, but might need to make earlier cash outlays or place bigger orders. On the flip side, companies may pay more per unit to purchase locally, but avoid an upfront cash outlay. There is no one-size-fits-all approach. The key is to understand the implications of different strategies so you can make an informed decision.

3. Making it visible – cash flow reporting

To truly foster a cash management culture, you need to actively track your cash flows. Forecasting is a critical step in cash management and ultimately improving profitability. This involves looking at both income and cash flow statements, and linking your cash flow forecasts to key working capital metrics from the balance sheet, such as DIO (days inventory on-hand), DSO (days sales outstanding) and DPO (days payables outstanding). As well, be sure to include capital expenditures, debt repayments and other operating cash flows so that management is aware of the full spectrum of cash requirements. To enhance the accuracy of these forecasts, consider automating this process rather than relying on error-prone and labour intensive spreadsheets. It is helpful to actively review variances in actual results as compared to forecast and use this process to refine and improve the accuracy of your forecast assumptions. Also be sure to integrate cash flow forecasting with your P&L statement and balance sheet so you can track performance against a range of indicators.

When times are tight, cash management can be even more important, buying time with key stakeholders, reducing the likelihood of covenant breaches and minimizing the need for additional financing. Be ready to move to weekly cash flow forecasting and reporting to improve visibility and reliability of information, and consider establishing a cash committee to oversee this process and drive change through the organization.

4. Matching funding to your cash flow obligations

Every business has both short- and long-term cash flow obligations. Short-term requirements encompass day-to-day operational expenses. Longer-term obligations typically refer to capital project investments and term debt maturities. To become proficient at cash flow management, companies must match their various sources of funding to their capital flows. This can ensure that an otherwise profitable business has access to the cash it needs to meet its ongoing obligations.

Taking an enterprise-wide approach to cash management

You can't manage cash in a vacuum, particularly if you have various locations, branches or retail outlets. That's because you need the ability to resolve cash flow crunches no matter where they show up across the extended enterprise.

To gain an enterprise-wide view of cash management, it's important to track your sources and uses of cash by both type and location. It can also mean engaging functions such as sales, procurement and operations more meaningfully in the cash management process.

By gaining a holistic view of your cash flows, you should be able to answer the following questions:

- How does cash flow around the enterprise and what responsibilities/accountabilities do finance, and other functions have in relation to cash management?
- How do you compare to internal and external benchmarks, are you meeting the norms for working capital turnover in areas such as DSO, DPO and DIO?
- Do you have capital spending plans in place and have these been matched with corresponding sources of the required cash?
- How much cash do you need to hold in each location? What is your process for funding different business locations that may be experiencing short-term cash flow shortages?
- How are cash generation and preservation actions encouraged and incentivized across the enterprise?
- If you consolidate your various bank accounts and/or streamline the way each location collects receivables, can you reduce the amount of cash trapped in transit?
- Do you optimize the matching of cash and capital flows in both the short and long term through the alignment of debtor and creditor terms with one another and through the proper matching of capital spends with capital sources?
- Is working capital performance a component of staff and executive compensation?
- If you were able to free up cash from working capital what would be the most beneficial use for it?
- How would a significant change in interest rates or sales volumes affect cash flow?
- Do you have a plan in place in the event you need to change your dividend policy (i.e. to go from a cash-only dividend to combined cash and stock, or stock only)?

Getting cash fit

In today's increasingly competitive business environment, companies need whatever edge they can get. That's especially true when it comes to improving free cash flow. Beyond simply enhancing your accounts receivable, accounts payable and inventory management processes, adopting a working capital strategy can position your company to outperform its competition. In essence, enhancing your cash flow management positions you to improve operational efficiency, better manage your cost of capital, mitigate operational and financial risks and improve shareholder value.

To realize these benefits, however, you need to understand working capital best practices, adopt a cash management culture and benchmark against industry leaders. We can help on all fronts. Deloitte's working capital professionals work with your teams to not only uncover process gaps, but also to tactically implement new processes, policies and metrics that deliver long-term performance benefits. You work hard to earn your cash. Isn't it time to get your cash working hard for you?

notes

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