How to be better off at no extra cost

Delving into the mechanics of credit and collections, payables management and inventory levels can pay dividends. **SUSAN A. HILLMAN** and **DANIEL L. BLUMEN**, of Treasury Alliance Group LLC, explain how to get access to free cash.

A defining trend of the past decade has been the work that multinationals have done to centralise liquidity, risk management and banking for their global operations. Enterprise resource planning systems, web technology and improved sophistication in banking systems and services have helped the process.

A danger in this worthwhile trend is that a simple focus on treasury centralisation and technology can lead to a false sense of security. Companies need to look "under the hood" and get their hands dirty with the mechanics of credit and collections, payables management and inventory levels at all operating subsidiaries.

In today's economic climate with tight credit, a focus on working capital management throughout the global enterprise is the single best way to generate free cash.

However, two issues can get in the way:

- For many companies, operating subsidiaries are focused and evaluated on a P&L, not a balance sheet basis. So it's necessary to develop a shift in measuring operating performance that will be reflected in a slimmed-down balance sheet.
- Setting global standards for inventory levels (turns) and/or Days of Sale in Inventory (DOS), Days Sales Outstanding (DSO) and Days Payable (DP) is extremely difficult and unrealistic. Nuances relating to the overall country environment, government regulations, standard commercial practices, competitive factors and even cultural considerations will impact how working capital can be managed effectively.

The key focus

Total Working Capital is defined as Inventories plus Accounts Receivable minus Payables as reflected on the balance sheet at month end. The carrying cost of this working capital is based on the actual interest that the company must pay in order to raise cash before inventories are turned and receivables collected.

In ideal circumstances, the collected receivables finance payables and inventory. If this is not the case, external short-term (working capital) funding is required. Thus, in order to reduce the overall borrowing and related costs, it's important that internal cash is utilised before external financing takes place.

A quick and simple method to determine the impact of this is to bring everything to the same basis – usually "days" – as opposed to turns.

For example, let's assume the company is in a borrowing position and requires $50m on an annualised basis in outside finance at a hypothetical annual rate of four per cent. Basically, the number of "days" in working capital can be determined as follows:

- **Inventory/(Annual Sales/365) = DOS (Days of Sales in Inventory)**
- **Receivables/(Annual Sales/365) = DSO (Days Sales Outstanding)**
- **Vendor Payables/(Annual Vendor Payables/365) = DP (Days Payable)**

Therefore, if inventory levels can be reduced by five days, cash collections can be accelerated by 10 days, and payables slowed by seven days the benefit is 5+10-7, or 22 days' improvement in working capital.

> 22 days x 4%/365 x $50 million = **$120,500 thousand in annualised interest savings**
> **OR**
> $183.3 thousand/4% = **$3 million in annual borrowing reduction**

That's a good return for a focus on working capital details. But this improvement in working capital can be achieved only once treasury determines the optimal guidelines or best practices for the company given the type of business and the countries where it operates.

Companies need to look "under the hood" and get their hands dirty with the mechanics of credit and collections

Evaluation

The approach to achieving improvement does take time and requires both internal and external research and assessment. Many companies are controlling expenses and for treasury this means that any type of project may be assigned a low priority. But with an example like the one above, any up-front expense is going to be recovered many times over. In reviewing working capital practices at the business unit level, there are a number of approaches that can be taken:

Internal reviews – This is an effective and rewarding approach with ancillary benefits that include training and forging bonds with operational. But it is a time-consuming undertaking and requires a dedicated team approach across business areas and geographies.

Use of external consultants – This is a good way to concentrate on key countries/operations and achieve results quickly. Once again, though, locating a consultant with whom you are comfortable – and who understands treasury – can take time and expense.

Contracted benchmarking surveys – This is where a single company attempts to determine the appropriate levels of working capital metrics for its industry. It involves the use of questionnaires specifically designed to generate information regarding performance, procedures and staffing levels. The downside to this approach is that it tells you what is, but not what to do about it.

Generalised benchmarking – there are many surveys and studies that have been undertaken by larger research firms in order to benchmark the overall working capital performance of companies. This approach often falls short in that it is based on consolidated information that often skews the results, gives no detailed insight into what is behind the raw numbers and offers no specific remedies for achieving improvements.

Basic steps

If treasury is responsible for cash and financing, it needs to take ownership of working capital management. Once the situation has been evaluated, some basic steps that can be applied by country include:

Inventory

Institute supply chain management focus and techniques:

Evaluate inventory at a more detailed level – raw materials, work in process and finished product – and determine over/under capacity by group.

Are inventory levels based on sales forecasts or historic order patterns? Sales forecasts are often optimistic.

Are production supplies and/or other inventory materials locally sourced to allow for just-in-time delivery?

Set DOS objectives but factor in considerations such as import quotas, labelling requirements and inspection issues.

Accounts receivable

Focus on DSO of your top 5–10 customers; assign a sales or customer representative to handle these key clients:

Institute follow-up on past due accounts, again concentrating on key customers, after a week, not just at month end.

Review payment instructions; are they clear as to payment instrument, timing and remittance requirements?

Request electronic payments. This can be difficult to achieve in some countries because of systems or culture.

Ensure that billing is carried out as frequently as feasibly possible.

Accounts payable

Fully centralise the payables function to the greatest extent possible. Setting up a Shared Service Centre can be a very effective tool.

Develop key supplier relationships globally and obtain discounts. Even if this means paying a single supplier more quickly, the improved terms will more than pay for the initiative.

Use credit cards or payment cards where possible for many purchases. This provides your company with a discount and lowers the cost of making a payment.

Understand and pay according to the commercial and cultural standards of the countries where you operate. Germany, France, the UK, Italy and Spain are all EU countries but payment standards vary widely in each of them.

Move to EDI/EFT wherever possible – there is no such thing as loss of disbursement float, but there is increased control of debit timing and a significant reduction in administrative costs.

The benefits

Investing time and resources on understanding, assessing and improving working capital at key business units is a way for treasury to make a significant value-added contribution to the corporation. It can have a more lasting and significant impact than simply getting better spreads on a single hedge transaction or a few basis points on the latest financing.

It also allows treasury to interact and understand the issues and constraints that business units must face on a day-to-day basis. Most significantly, it gives a company access to the cheapest cash in the world – its own.