

Working Capital Management is Always Crucial

As levers of financial management go, none bears more weight than working capital. The viability of every business activity rests on daily changes in receivables, inventory, and payables. It's the lifeblood of the business, and every financial manager's primary task is to keep it moving and put capital to work efficiently and effectively.

The relative lack of attention to working capital management is rooted in its highly integrative nature. Working capital touches many points in the company, making optimization particularly difficult. Flows of product and information, as well as customer relationships, touch many divisions, from sourcing through production to fulfillment and accounting. Coordination of information and activities across divisions is a significant challenge.

Keys to effective working capital management include:

- ✓ Manage accounts payable to match receivables
- ✓ Leverage suppliers' and customers' operations to improve your cash management
- ✓ Tie compensation to working capital improvement
- ✓ Look for alternative financing to get receivables off the books (factoring)
- ✓ Develop a culture that strives for continuous improvement

The first step in working capital management is to measure your cash conversion cycle (CCC). The components of this calculation are as follows:

Days Sales Outstanding (DSO): $AR / (\text{net annualized sales} / 365)$

Measures average collection period for sales. Computed as trade receivables net of allowance for doubtful accounts, plus financial receivables, divided by net sales per day. A decrease in DSO represents an improvement, an increase indicates deterioration.

Days Inventory Outstanding (DIO): $\text{inventory} / (\text{annualized net sales} / 365)$

Measures average time required to convert materials into finished goods and then to sell those goods. Computed as inventories divided by sales* per day. A decrease in DIO represents an improvement, an increase indicates deterioration.

Days Payables Outstanding (DPO): $AP / (\text{net annualized sales} / 365)$

Measures average payment period for purchases and costs. Computed as trade payables divided by sales* per day. An increase in DPO represent an improvement, a decrease indicates deterioration.

Days Working Capital (DWC), or Cash Conversion Cycle (CCC): $CCC = DSO + DIO - DPO$

Measures the length of time between when a company makes payments and when it receives cash. Reducing CCC represents improvement, whereas an increasing CCC represents deterioration.

**Note: Many companies use cost of goods sold instead of net sales when calculating DPO and DII. Using net sales across each working capital component allows a balanced comparison across each DWC/CCC. Whether you use net sales or cost of sales depends on which provides your company with the best information you can work with.*

The cash conversion cycle (CCC) provides management with a good measure as to how long the company must fund its operating cycle. For example, if your salespeople are using payment terms as sales incentives, resulting in DSO of 55 days, your inventory turns every 40 days and you pay suppliers in 30 days, then your cash conversion cycle is 65 days (55 DSO + 40 DII - 30 DPO). In other words, you will need to fund this period with either debt or equity capital (including retained earnings), which carries a cost.

The goal of the business is to minimize its cash conversion cycle, and thereby reduce the amount of outstanding working capital. This requires examining each component of CCC discussed above and taking actions to improve each element. To the extent this can be achieved without increasing costs or depressing sales, they should be carried out.

Many companies have experienced noticeable working capital improvements by wrapping the goals of improving cash flow and working capital into their compensation programs. Motivated employees that see their year-end paycheck affected by what they are able to do in this area gives the biggest bang for the buck.

Managing Accounts Receivable

Changes in monthly sales trends, changes in prices, variations in product mix, as well as actual invoicing practices can influence DSO. DSO represents the order fulfillment cycle and can be broken into three major components:

- shipment to invoicing – reduce delays between shipping and invoicing dates;
- invoice date to customer payment – primarily managing payment terms; and
- customer payment to invoice closure – managing dispute resolutions.

Customer payment practices are not the only challenge to reducing receivables. Sales and marketing managers are understandably highly interested in an issue that directly impacts the customer relationship. Altering terms or even making sure that customers are living up to agreed-upon terms can be a very sensitive subject.

Managing Inventory

Successfully addressing the challenge of reducing inventory requires an understanding of why inventory is held and, therefore, where it builds in the system.

Achieving this goal requires a focus on inventory improvement efforts on four core areas:

- inventory optimization – using statistical/finance tools to monitor and set inventory levels;
- demand management – information integration with both suppliers and customers;
- transportation and logistics – lead time length and variability; and
- supply chain planning and execution – coordinating planning throughout the chain from inbound to internal processing to outbound.

Managing Accounts Payable

The accounts payable department is often a poor stepchild in terms of management attention. Many companies think simply in terms of “collecting as fast as possible, and paying as slowly as permissible.” This strategy, however, may not be the wisest.

First, at the same time you are attempting to integrate more completely with your customers—and realize the related benefits—so too are your suppliers attempting the same integration with you. A “pay slow” approach may not optimize either your accounts or your inventory, and is likely to interfere with the establishment of a smoothly meshed supplier relationship. As previously noted, a lengthy cash

conversion cycle adds financing costs. Understanding this cost of financing will help you to negotiate terms with suppliers.

Summary

The faster a business expands, the more cash it will need to fund working capital and investment. Good management of working capital will generate cash, help to improve profits, solidify relationships with suppliers and customers, and reduce risks. When it comes to managing working capital, time is money. If you can get money to move faster—speed the cash conversion cycle—by, say, reducing the amount of money tied up in inventory or accounts receivable, the liquidity of the business increases and incremental cash flow can be generated. Likewise, the business may be able to reduce its debt and interest expenses. If you can negotiate improved terms with suppliers, e.g., obtain longer terms; you can leverage financial resources in new ways. Money trapped in working capital is money not being used to grow.

How does your company's working capital management efforts compare to your competitors or in your industry group? You can make these determinations by utilizing available information such as the quarterly and annual reports published by companies subject to SEC reporting requirements, and other published data in publications such as the **RMA Annual Statements Studies**.

If you need assistance with your working capital management needs, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail dhillier@harvestcfo.com. Also, please visit our website at www.harvestcfo.com.

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