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Gresham Considine

Better Outcomes

Cash and Working Capital

“The life and soul...........”

There is universal agreement amongst business executives that the efficient use of cash is an important aspect of any business. Yet in many businesses executives find it difficult to get it right. In our experience there is often an opportunity to better manage cash and working capital, thereby generating additional, possibly much needed, available cash resources. Internally generated cash is the cheapest funding available to a business.

In this article we set out a number of ideas and processes to better manage cash and improve working capital usage under the following headings: –

1. Summary
2. Assessing the Short-Term Cash Requirement
3. The Cash Management Process
4. Working Capital Improvement

1. Summary

Significant opportunities, often running into millions of pounds, exist to better manage and generate cash. Key points which we expand upon in this article are:

- A 12 week rolling cash flow forecast is a vital cash management tool and should be structured to separately highlight the operating cash flow requirement.
- Day-to-day cash management should be in the hands of a cross functional team, thereby creating cash flow awareness through the key functions of the organisation.
- Centralisation of cash management is important. In groups of companies, subsidiaries should be cash rationed.
- The opportunity to generate additional cash from better working capital usage tends to be in receivables and inventory.
- Multiple actions (as set out in this article) may well be required to reduce receivables Day Sales Outstanding (DSO) and thereby generate cash, proactive collections being key to reducing DSO.
- Inventory can be reduced by changing parameters used in planning and scheduling, for example safety stock. Further reductions can be achieved by better aligning inventory holdings to demand by applying a double S curve analysis. However to achieve world-class inventory management it may well be necessary to re - engineer the supply chain

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Assessing the Short-Term Cash Requirement and the merits of a 12 Week Rolling Cash Flow Forecast

The visibility of actual available cash is needed on a daily basis.

The starting point for any cash management program is to understand what has to be managed. The tool is a 12 week rolling cash flow forecast. The cash flow should start from a known cash position which is reconciled to an opening balance sheet. As the debtor and creditors ledgers will initially drive the short term cash flow a review of the ledgers should take place to ensure they are fairly stated. The cash flow is updated and rolled forward each week.

The cash flow should be on a receipts and payments basis as this will enable the analysis of weekly variances when compared to actual receipts and payments. Variances from week to week should be investigated to determine the extent to which they are controllable and used by the forecasting team to enhance future forecasting accuracy. This can be extremely detailed work and may very well involve investigating receipts debtor by debtor and payments supplier by supplier.

In situations where the business is funded through a multi - bank arrangement it's necessary to structure the cash flow to project the available headroom facility by facility. The forecast should be prepared on a business as usual basis so that the management team can understand the quantum of the cash management challenge when compared with existing facilities. The impact of individual improvement levers (see below) can then be overlaid on the forecast.

"The fact is that one of the earliest lessons I learned in business was that balance sheets and income statements are fiction, cash flow is reality."

Chris Chocola

"A 12 week rolling cash flow forecast is a vital cash management tool and should be structured to separately highlight the operating cash flow requirement."

The cash flow should be prepared on a cashbook basis. The difference between the balances in the cashbook and cleared funds at the bank is known as the bank float. For many businesses the bank float is reasonably consistent, where this is positive (that is the overdraft is higher in the cashbook than recorded at the bank) it can form a contingency where it is negative the quantum should be provided for in the headroom calculations.

The cash flow should be produced on a prudent basis, as lenders prefer to see actual cash requirements being below those forecast as opposed to continual requests for additional cash over and above the forecast. However, management need to balance a prudent forecast against the quantum of a new money request that any such forecast may determine. As the quantum of the new money request could result in lenders taking precipitate action by withdrawing support or demanding an extremely high price for providing the quantum of new money forecast. This may not just be a monetary price but also management change.

Cash flows presented to lenders should clearly separate the cash required for business operations and that needed for one off items, for example the cost of restructuring, and cash needed to service and pay down debt. In this way lenders can clearly see the cash needed to protect and build value by continuing business operations from which debts will be serviced and paid down. The operational cash requirement and the possible moratorium on finance payments can then be assessed against the potential outcomes of such other options the lenders may have.

In addition to comparing the short-term forecast cash requirement on a weekly basis to the actual receipts and payments the month end balances of the rolling cash flow forecast should be reconciled to the company's medium-term monthly forecasts as a reasonableness check of the short term forecast. The medium-term forecasts should be based on an integrated financial model containing, profit and loss accounts, cash flows and balance sheets.

The Cash Management Process

Having prepared a short term cash forecast and compared it with the medium-term forecast to assess its reasonableness management is now face the challenge to manage the cash to remain within current facilities, with appropriate headroom, or to mitigate the quantum of new money that may be required. Management, specifically the board, has to develop a cash management process. The individual running the process should report to the board as frequently as the situation demands. The current and future cash position of the business should be high on the board's agenda.

The demands on management teams of stressed companies can escalate rapidly and it is not unusual for a management team to recruit interim assistance to manage cash. Often the cash manager will have executive authority reporting directly to the board alongside the financial director. Where a chief restructuring officer (CRO) role is deemed necessary, this may well form part of the terms of reference.

The immediate task facing the cash manager is to gain control of cash and to form a cross functional cash management team. This requires people of appropriate calibre to be diverted into managing cash. A cross functional team creates awareness through the organisation that the management of cash is not just the responsibility of the finance function but the whole business.

In smaller businesses the cash manager can gain control by removing authority from other managers within the business, above certain limits, for both committing the business through purchasing and paying suppliers for goods and services already delivered.

In larger businesses which will invariably be multi-site and very possibly multi-national the cash manager will have to work through a hierarchy of controls and authorisation levels. Nevertheless even in such situations the thrust of the cash manager must be to centralise control over cash and commitments. Where there are multiple bank accounts the treasury tools of daily cash sweeps and pooling should be used.

In group situations to remove the expectation on the part of subsidiary management that group treasury will provide for cash shortfalls a system of subsidiary cash rationing should be considered.[1]

The cross functional team should include senior managers from sales and marketing, receivables management, finance, operations and procurement. The team should meet on a weekly basis, or more frequently if required, to consider how cash should be spent across the business.

In addition to prioritising payments the team will also have responsibility for the revision of the short-term cash flow forecast based on actual receipts and payments and changes in the view of the future. The team will also be responsible for leading the development and implementation of working capital improvements to generate additional cash.

"Day-to-day cash management should be in the hands of a cross functional team, thereby creating cash flow awareness through the key functions of the organisation."

In prioritising payments the cash management team should focus on the core processes of the business. This may well mean that in the short term, non-essential expenditure is deferred, for example capital expenditure. In addition to prioritising payments to suppliers the cash management team should authorise all purchase orders, above certain limits, to control the input into the purchase ledger which would ultimately result in the need for a payment. In a manufacturing business this will entail reviewing and agreeing the short term production schedules.

Working Capital Improvement

Our experience has taught us that often very significant additional cash running into millions of pounds can be generated from better working capital management. Quick cash can be generated through the better management of receivables and payables whereas generating cash from inventory will take longer and may well entail the need to reconfigure the supply chain.

Payables

Simply increasing the credit period taken from suppliers will quickly generate cash. However, in stressed companies the opportunity to do this before the company is put on stop by suppliers may well be limited. Further, in situations where the company's solvency is questionable extending credit from suppliers in this way should be considered against the background of the wrongful trading provisions[1]. In such circumstances the directors will need to very carefully manage this particular risk. That said, the renegotiation of credit terms with major suppliers should be considered as a form of support. The possible failure of the company may well be of considerable significance to such suppliers. Alternatively, it may prove possible to move to vendor managed inventory whereby the supplier funds raw material inventory.

Similarly major customers may well provide support, for example by accelerating payments, as the failure of a key supplier would have a serious impact on their own business.

In our experience the open and honest dialogue with major suppliers and customers has proved beneficial in a number of cases.

The cash management team should quickly review on an 80/20 basis the actual supplier payables profile to ensure that suppliers' payments are not being made ahead of the credit period set out in the suppliers' terms of trade.

In prioritising payments to suppliers the input into the team's decision-making process by operations and procurement is vital to understand the impact that prioritisation may have on the continuing operations of the business.

In recent years HMRC has provided very significant working capital to UK corporates under the time to pay scheme and although this scheme is being scaled back nevertheless HMRC can still be a source of much needed short-term working capital provided an open and honest dialogue is entered into supported by detailed plans and forecasts which clearly set out how the extended debt due to HMRC is to be returned to acceptable credit periods.

"We have begun to aggressively implement best-practices throughout the company and have put stringent controls into place to improve inventory turns and working capital efficiency, which will enable the business to internally finance the cost of change"

Luis Padilla

Receivables

Cash needed to fund the receivables cycle is ordinarily measured by the number of days sales which equates to the receivables balance, this statistic is termed days sales outstanding or DSO. Key drivers of the DSO for any particular customer are, the credit period contained within the terms of trade, the frequency of invoicing and the efficiency of the collections process. The timing of invoicing should be as close as possible to the delivery of goods or services.

Quick cash can invariably be generated by improving the collections process. In the side bar we set actions that can be taken to improve collections thereby lowering the DSO and generating cash.

"Multiple actions may well be required to reduce receivables Day Sales Outstanding (DSO) and thereby generate cash, proactive collections being key to reducing DSO."

"Money: Power at its most liquid"

Receivables Collections - Side Bar

- ***Measure*** the efficiency of the collections process by the percentage of the ledger which is outside terms and overdue. Focus on accounts that have an overdue element.
- ***Prioritise*** by using the 80/20 rule to segment the ledger and focus collectors' time upon the higher value over due accounts thereby achieving the greatest improvement quickly.
- ***Allocate*** accounts to collectors to establish individual accountability for the improvement targets. Focus collectors on collecting and where possible reallocate other activities.
- ***Calculate*** days sales outstanding (DSO) and set reduction targets to significantly reduce the overdue percentage in the ledger.
- ***Project*** future monthly DSO targets and determine the associated monthly cash collection targets. Allocate targets to collectors and monitor daily. Use flip charts in the collections area to visibly record daily progress thereby creating a degree of peer pressure.
- ***Process*** collections pro-actively rather than a reactive 'dunning letter' process. Call major accounts before the due date to get cash pledges and provide time to resolve disputes. It may be beneficial to outsource the collection of accounts below a certain debt level.
- ***Contact*** with customers on a regular basis will enable a better understanding of the causes of overdue accounts. Maintain a customer call log which records the reasons for non-payment and the means of settling disputes.
- ***Develop*** from the call logs a dispute feedback loop. The issues recorded in the call logs should be discussed at weekly meetings of a cross functional team, the objective being to fix systemic operational and administrative errors which give rise to non-payment and the issue of credit notes. This will assist clean deliveries and invoicing and will improve competitiveness by increasing the OTIF.
- ***Seek*** direct payment transfers.
- ***Consider*** early settlement discounts.

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Inventory

Initially construct an inventory map, that is, its classification (Raw material, WIP, finished goods, good, slow moving, obsolete, by business unit/product group/market) and physically where it located. Typically, in a stressed company situation there are three approaches to reducing inventory as set out below in order of the speed of payback:

Parameter changes

Inventory can be categorised as follows;

- A - fast moving items known as runners
- B- slower moving items but still current known as repeaters
- C - slow-moving obsolete items known as strangers

Where the lines are drawn between the above categories can have a significant impact on the amount of inventory held as discussed below under inventory alignment.

Changes to the parameters that are used in planning and scheduling will reduce inventory. In fact, the quickest way to reduce inventory is to focus on the parameters that are driving the main products (runner products) within a business since the effect of changing parameters will start filtering through on the next materials requirements planning (MRP) run. Changing parameters for slower moving products (known as repeaters and strangers) will obviously need a greater time to make an impact.

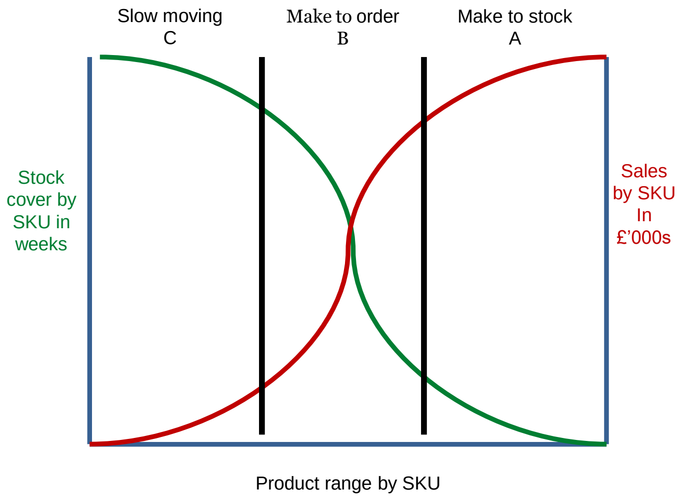
Typical examples of parameter changes include, batch sizes, safety stock levels, re-order quantities, customer order / delivery profiles. In changing parameters we are seeking to challenge the status quo, inventory parameters may well have been established some years ago and remained unchanged they become a general rule of thumb within the business. The level of safety stock is a good example of this tendency. Key factors in determining the required safety stock by stock keeping unit (SKU) are sales forecast accuracy, fulfilment lead-times, manufacturing schedule adherence and service level data. These factors should be regularly reviewed and updated on a SKU by SKU basis and not simply an historic safety stock number of weeks applied to all SKUs.

Other changes that should be considered include changes to roles and responsibilities to ensure inventory control comes under a single area across the business. Also, production and purchasing should have immediate focus to ensure production is aligned to the most recent sales forecasts. Too often purchasing and / or production will continue to make independently of such forecasts, resulting in waste and over-production / purchasing. The cross functional cash management team can play a vital role in better aligning the business to customer demand

Inventory Re-alignment

Having made changes to parameters, the next step is to address current levels/type of stock and where it sits in the supply chain. Too many companies have not enough inventory of their runner items, and too much inventory of their repeater / stranger items. The objective is to better align inventory to demand. To assess the opportunity to reduce inventory in this way it is necessary to model sales and inventory cover by individual SKU.

Inventory Double S Curve



The above diagram is a representation of modelling inventory by SKU by sales and weeks cover. The red S curve is sales by SKU and the green S curve is weeks cover by SKU. Not surprisingly, SKUs with high sales values tend to low inventory cover and visa – versa.

Inventory Re-alignment cont……..

Where the demarcation lines are drawn between A, B and C inventory categories will have a potentially significant impact on the extent of the product range ,the complexity in the business and consequently on inventory levels. For example, at one client 5000 finished product SKUs came from 50 blank varieties yet all were delivered ex stock. Based on the above double S curve analysis, working with production and marketing we were able to remove the majority of the finished product SKUs categorise the stock into A, B and C categories and, as a consequence, reduce the inventory held by 50%.

The objective of the above technique is to better match inventory to demand. It should be borne in mind that demand is dynamic therefore this analysis needs to be undertaken on a regular basis to avoid the proliferation of SKUs and the associated inventory.

Process Re- engineering

Ultimately, world class techniques are required to make businesses high performers with relation to inventory. This includes such techniques as pull manufacture (or demand driven manufacture), Just-in-time, lean manufacture, lead time reduction, cell manufacture, focused factories and so on. If these techniques do not exist, it may very well be possible to radically reduce inventory. Realistically in stressed companies, a pragmatic view is needed as to whether it is in the company's best interests to try to implement these types of techniques, or whether enough benefit can be achieved through addressing the other areas above. Detailed process re-engineering entails greater risk as the core processes of the business are being re-engineered and require a longer time scale typically 3 to 6 months.

> ***"Money is always there but the pockets change; it is not in the same pockets after a change, and that is all there is to say about money."***
>
> Gertrude Stein

Conclusion

In this article we have briefly outlined potential opportunities to better manage and generate cash. In our opinion such opportunities are available to many businesses. Internally generated cash is the cheapest source of funds. In our experience external funders when asked for additional funds view favourably a business that is seen to be helping itself by generating internal funds from better cash and working capital management.

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Footnotes

1 Cash rationing is where a subsidiary is given a cash budget by group and has to remain within it.

2 The principle of wrongful trading was introduced in the Insolvency Act 1986, to complement the concept of fraudulent trading. Unlike fraudulent trading, wrongful trading needs no finding of 'intent to defraud' (which requires a heavy burden of proof). Wrongful trading is therefore a less serious, and more common offence than fraudulent trading.

Under UK insolvency law wrongful trading occurs when the directors of a company have continued to trade a company past the point when they:

- "knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation"; and
- they did not take "every step with a view to minimising the potential loss to the company's creditors".

Where, during the course of a winding-up, it appears to the liquidator that wrongful trading has occurred, the liquidator may apply to the Court for an order that any persons who were knowingly parties to the carrying on of such business are to be made liable to make such contributions to the company's assets as the court thinks proper.