Working capital management:

taking an organic approach

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In a recent survey of corporates at Finanzsymposium in Mannheim, Germany, 85% said working capital management will rise in importance in the future. Extrapolate this figure to the wider global corporate community and, give or take some statistical license, it is not difficult to see that in order to meet future needs, now is the right time to invest in process improvements.

Every profession has a small set of activities that are fundamental to the successful execution of their role. For the treasurer, working capital management (WCM) sits at the beating heart of corporate endeavour and is amongst the core elements needed for survival. If ever such a claim was in doubt, take away the control mechanisms that keep the company liquid and start timing how long it takes before the vultures start circling.

Treasurers have always been the custodians of corporate cash, ensuring optimal liquidity, securely deploying any surplus or borrowing sensibly. But in today's strained economic environment, simply putting cash on deposit, when that deposit is subject to unprecedented negative rates, can be costly. And if borrowing, it is flirting with disaster if a company expects its banks to agree to almost any facility. Times have changed and there is no longer a 'one size fits all' answer to the question "what shall I do with my cash?"

With approaching 30 years of industry experience, Kevin Grant, Member of the Executive Board at financial software and services firm, Hanse Orga, takes the view that today's treasurers need to adopt a global vision of company cash. In WCM terms, treasury can be seen as an "overlay function" that looks at, and acts on, information received from operational regions and countries, entities within countries and the bank accounts and facilities they hold. Decisions around surplus cash and cash requirements will thus be influenced by a multitude of factors. Take seasonality of cash flow across the entire business, for example.

An ice cream seller makes money in the summer but will call upon reserves or borrow in winter to get by. This is perhaps an over-simplistic example but transposing it to a major international corporate will maintain the same seasonality effect, even if the demand on cash is extended dramatically. The matter is of course compounded for corporates when their activity takes place across different regions. 'Ice cream selling' – and its metaphorical corporate equivalent – suddenly takes on a whole new complexity.

Changing drivers

Whilst companies have always had to manage working capital in order to survive, for obvious reasons the act of 'working capital management' has come to prominence since the financial crisis of 2008. For treasurers, executing this core activity in the face of adversity must assume a new profundity – and nowhere is this more relevant than where operational complexity exists. This will almost certainly be a matter of concern for the treasury profession.

Indeed, for Grant, almost by definition treasury exists in organisations that are in "such a mature stage of their development" that they are undertaking cross-border trade. For those businesses that have grown into multinationals (MNCs), with overseas entities and banking relationships and facilities to match, international trade will involve the flow of multiple currencies across the organisation. This, he notes, will inevitably create transactional exposures – these typically being associated with payables and receivables – which in turn require risk mitigation processes to be in place.

However, in order to expand, an international organisation demands foreign investment. A new overseas manufacturing plant, for example, may require a company to borrow locally to ensure it has the local currency, or the currency of the contract, to keep the project on track, and this has to be funded. The considered WCM view may suggest that rather than using free cash flow to support a long-term capital investment, it may be more prudent to borrow longer-term, by issuing a bond or going to the commercial paper (CP) market, for example. This loan, rather than absorbing free cash, then becomes a de facto cash generator and, unless there are regulatory constraints, this cash can be repatriated and used to pay down the principal on the agreed loan and interest.

No KPIs

In making working capital decisions, traditionally a company would look at its P&L statement on a monthly basis and ask if it was generating the cash expected from sales activities, and also if it is controlling the cash going out of the business on the 'accounts payable' side (taking this as a generic term to include internal costs such as staffing and office management). "This is not good enough because it only offers a snapshot of a backward looking accounting statement," states Grant.

A company might also look at its balance sheet on a monthly basis because this will reveal what cash is trapped in 'work in progress' (such as the sale of software or a service); the contractual terms around the delivery of this sales offer will influence the company's ability to take that income into the P&L statement. "Ultimately, whether a company uses the balance sheet or the P&L for its working capital management, these are just accounting statements."

Indeed, they give no information as to whether an invoice has been raised in time, if the customer has paid in time, or if the business is paying earlier than it needs to pay. For Grant, even if a business knows what its days sales outstanding (DSO) and days payable outstanding (DPO) activity is, it is not clear what is influencing and impacting this activity on a day-to-day basis if these elements are not being monitored as key performance indicators (KPI) of business processes.

Effective WCM is therefore more than just DSO and DPO from the invoice cycle; it is about cash in the bank account, and a host of other forecasted committed-costs that the company has. Of course, these should be picked up through the budgeting process. But consideration too should be given to monthly refreshes of the typical 12-18 months rolling forecast, the sales and expenditure expectations of each operating unit and treasury's own borrowing and investment cycles and commitments.

Deeper working relationships

Biologists talk about the symbiotic relationship between certain different species, describing how one supports the other. Within business, it is easy to see how different functions interact as a living organism, with great potential for mutual benefit. But, says Grant, this 'mutualism' can and should extend beyond internal relationships. Corporate buyers working closely to support their suppliers can help to maintain supply chain stability. Indeed, as part of the Finanzsymposium survey mentioned earlier, almost half of respondents said customer behaviour and DSO was the area of greatest opportunity to maximise the effects of WCM.

In commerce, most businesses rely on their suppliers. If they start to lengthen business terms they run the risk of making those suppliers financially unstable, notes Grant. Putting a stranglehold on the companies you are dependent upon for your own production and subsequent sales is, he believes, "a very short-term view" that risks becoming "a self-fulfilling demise" for all parties. "But has it stopped large multi-nationals doing it?" Clearly not.

The common WCM approach to extending DPO and shortening DSO is to offer a supply chain finance (SCF) programme, he comments. SCF is a tri-party arrangement, with a financial institution sitting between the buyer and supplier. Where a supplier wishes to receive early payment, it is charged a fee in the form of an interest rate based on the creditworthiness of the buyer. Here, the burden of the financing cost is borne wholly by the supplier. "It may give the supplier its cash earlier, but it is cash that comes with a cost. I would question whether that really is supporting the supplier, or whether that is a buyer-preference model."

More reasonable perhaps is the bi-party arrangement, where the buyer gives the supplier the option to take earlier payment for a discount set by the supplier with buyer approval. Dynamic discounting, as it is known, comes out of the free cash flow of the buyer and therefore does not require any financing third-party involvement. "That is a closer working relationship in my view and one that maintains a healthy collaborative symbiosis between both parties."

A difficult view

As organisations begin to realise that managing cash is a vital skill, the treasury function has come into focus. With a macro-level view of the process, the role is in a position to assimilate information from across multiple functions in order to make key WCM decisions. Where such functions may exhibit inefficiencies – such as the slow raising of a purchase invoice, incorrect or missing references, late delivery or claimed non-receipt – these situations are not observable if the business simply looks at the P&L or a balance statement at a group level. "Companies should be tracking these KPIs as part of the daily management regime," says Grant.

What is required is a system of delivering visibility in an easily digestible way. The refrain at this point may be that this is hard to achieve – and this is fair comment. Many large corporates are still entrenched in siloed operational units, with fragmented data flows exposing them to error. An otherwise professional treasury may be extracting data from a TMS, ERP and forecasting system and trying to consolidate group data – along with data from external partners such as banks – in spreadsheets, sometimes even outsourcing this process to a third party. "Quite often the consolidation process is not automated, there is a mix of electronic and paper-based data and people are re-keying numbers," notes Grant. Using the sum of this process as 'fact' is a dangerous occupation; if results even arrive in a timely manner, there is simply no way of efficiently verifying credibility.

All-in solutions

With organisations cognisant of the need to be more analytical and critical of their processes, the urge to fix the problem is rising up the agenda. Certainly there is acknowledgement by treasurers that today's systems are capable of meeting the challenge but this comes with the conflicting view that technical complexity is perhaps too high a price to pay.

The key is to have data sources circulating within the same homogenised environment. Best-of-breed systems are impressive in themselves but if all data sources flow within an ERP, the fabled 'single version of the truth' might seem more probable, says Grant. For him, an ERP gives access to planning data, treasury activity, accounts payable and accounts receivable, supplier and customer contract management information in one location and available the moment it is updated – even if it is manually keyed at the initial point of entry.

Digitised data can be used for straight through processing and reporting. Business intelligence (BI) and KPI tools, which also reside within the same ecosystem, may also be auto-populated with this data. From here, it is possible to start building management dashboards to address the issues around WCM "in a dynamic and real-time way". This can even be viewable in multiple channels, from smartphone to desktop, and be capable of providing group level information with resources to drill down into regional, country and even customer level, offering user-insight into various behaviours that impact cash and liquidity.

The counterpoint to this singular expression of company financial data is that, system-wise, this is asking for a monolithic structure; it will be complex, hideously expensive to build and resource-intensive to operate. "Things have changed," states Grant. "None of the ERP vendors have been sitting back, failing to tackle ugly and unfriendly user interfaces; none have spurned real-time reporting", he retorts. "They've been developing solutions to these issues: at SAP they introduced the HANA and they have built real-time reporting and BI tools around working capital. We also have the Fiori user-experience development environment which can give a completely new look and feel to navigating standard SAP screens."

The aim is to allow greater transparency, analysis and control over liquidity positions and business processes. Modern solutions also allow global process owners, particularly the treasury function, to respond more quickly to ad hoc requests on liquidity and to meet the increasingly strategic nature of such enquiries. Furthermore, says Grant, not only are treasurers able to proactively provide information to senior management and the board but also, if dashboard capability is adopted, it can give senior managers direct access to that information, in an easily digestible form.

In practical terms, it may be that a customer pays on time every time, but what is the cost of serving that customer? Profitability analysis, notes Grant, is a function of new ERP analytics. "It can reveal a very different story when balancing that cost with individual customer behaviour, especially when annual budgeting costs are added into the mix." There is a compliance issue here too, he adds. If a customer is not behaving in accordance with the commercial contract, easy access to information pertaining to this can prove "significantly advantageous" when applying such information to the overall analysis of WCM.

Ask an expert

Of course, the capabilities of an ERP system can prove somewhat overwhelming when seeking to optimise WCM. Within the realms of the system, treasurers may not even realise the full array of possible data sources that can be brought to bear on the matter, especially if they are not considered 'traditional' treasury sources. For Grant then it is the role of a company such as Hanse Orga to help unwind those complexities and to unlock the true potential of an organisation's technology.

Large corporates often have a fragmented technology landscape and, as a result, fragmented processes. It's a status that is all too easy to achieve. Deploying a best-of-breed approach will always create divisions between technologies and even if these divisions can be electronically bridged, it requires close planning to make those connections work. But fragmentation may also exist even if the organisation has an installed ERP, concedes Grant. Indeed, it is quite common to run different ERPs or multiple instances of the same system, across different locations (an effect commonly attributable to M&A activity). Help may be required.

"Consulting in the ERP space first means understanding what system the client has acquired, how this has been implemented and how can this be fine-tuned – because the same goals can be achieved in different ways," explains Grant. He accepts that the configurability of an ERP may be seen as both a strength and a weakness: if you know what you're doing it will be the former.

When it comes to fine-tuning an ERP to achieve a specific goal, Grant has a clear vision of how he wishes to operate. "We liken ourselves to [Mercedes-Benz performance tuning firm] AMG" he says. AMG does not sell cars but it takes many aspects of a standard vehicle – such as engine, brakes and suspension – and can tune these to whatever specification the customer wants. In much the same way, Hanse Orga does not sell the ERP but it fine-tunes the system to its clients' needs. In doing so it may bring in internally-developed add-ons or third-party tools (as indeed does AMG) to achieve the desired goal of de-fragmenting the overall treasury technology architecture. In many cases, just an expert's fine tuning of the standard parts can bring significant process improvement.

When the goal is to bring about a sea-change in WCM, where disparate sources of data are brought together in the kind of symbiotic relationship that can only yield positive results, Grant argues the case for a technology partner that has financial workflow automation expertise, BI capability and a pragmatic approach to delivery. "There is no point in automating everything and giving the client great solutions if in the end it does not give the organisation information that helps manage its business," he declares.

Tackling WCM efficiency demands the interpretation of a company's goals as a business, its incumbent technologies and its strategies. In taking a view of the "policies, processes and people" that drive it all, Grant asserts that "the cash impact of all these behaviours" becomes readily apparent. This is effective WCM. ■