



# Put Working Capital Back to Work

*There's never been a better time to reduce working capital requirements to speed financing and invest in future growth.*

By Lisa Higgins

If your company had an extra \$41 million, what would you do with it? For every \$1 billion in revenue, that's how much more cash companies that effectively manage their working capital have at their disposal.<sup>1</sup> According to APQC research, a top-performing *Fortune* Global 500 company reporting median revenues of \$30.7 billion enjoys a liquidity boost of \$1.3 billion. Add to that the \$1.4 billion that the company reaps because it has less money tied up in inventory and you're looking at an enormous cash advantage.

Within a given sector, lower working capital requirements and superior cash flow are key indicators of management's ability to balance revenues and capital deployment. During economic down cycles, when the competition is retrenching and cutting back, top performers are able to make counter-cyclical moves to build competitive advantage. Leveraging their cash advantage to grow and gain market share, they are able to fund projects internally and have an easier time getting external financing. This enables them to continue to spend money on R&D, upgrade facilities, invest in new equipment, and open new stores in promising markets. (See box, page 5, "The Flip Side of the Credit Crisis.")

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*"Top-performing Fortune Global 500 companies reap a cash advantage of \$2.7 billion."*

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This white paper reveals more of the dramatic financial benefits that can result from a concerted effort to improve working capital management. For finance managers, closing the gap between current performance and best-in-class starts with a clear understanding of the opportunity.

## **MORE THAN A NUMBERS GAME**

Simply put, working capital is the amount of daily operating liquidity available to a business. It describes the relationship between a company's short-term assets (inventories, accounts receivable, cash) and short-term liabilities (accounts payable, pending loan payments). The \$1.3 billion cash advantage cited above comes from having 15 fewer days of sales outstanding in accounts receivable (30 days for the top quartile vs. 45 days for the median and 55 days for the bottom quartile).

The thought of freeing up such a hoard of cash is enough to get any CFO's heart racing. With the volatile state of world markets today and tight credit curtailing the availability of commercial loans, no one's going to argue against the prospect of having more liquidity on the balance sheet. Oil, food, and commodity prices are at historic highs, and worldwide demand shows only short-term signs of easing off. At 5.7 percent, the July U.S. unemployment rate is a full percentage point higher than it was last year. The "misery index," the sum of the

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<sup>1</sup> Unless otherwise noted, all performance data is from the APQC Open Standards Benchmarking Collaborative<sup>SM</sup> (OSBC, [www.apqc.org/osbc](http://www.apqc.org/osbc)).

## PUT WORKING CAPITAL BACK TO WORK *(continued)*

inflation and unemployment rates, is at a 15-year high. And we haven't even mentioned housing prices. It's no wonder retailers are already predicting a dismal holiday season.

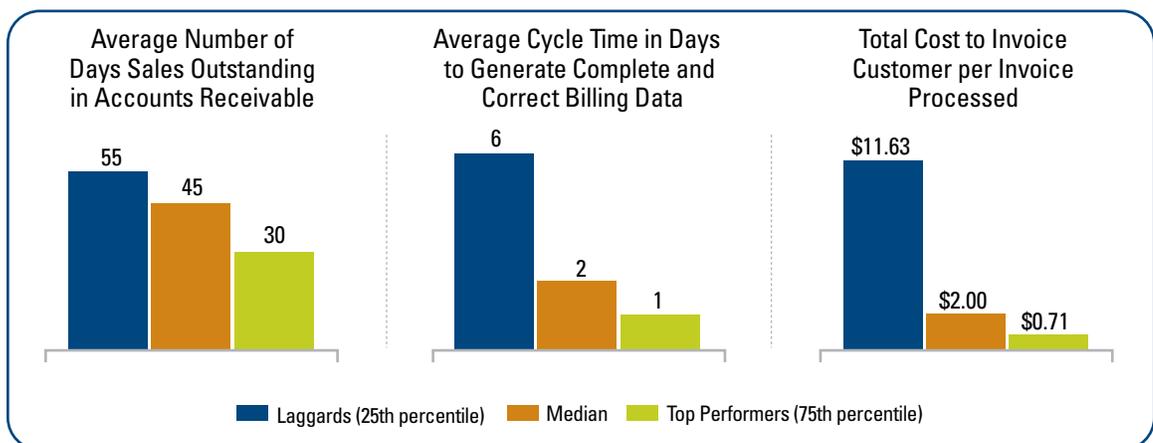
When dealing with such uncertain conditions, companies that are good at managing accounts receivable and forecasting and aligning inventories with demand have a clear advantage. Unfortunately, too many efforts to reduce working capital focus only on the short term. To make the numbers look better, companies will delay vendor payments or step up collections to close out the year on a high note, only to slide back to previous behavior and performance the following quarter. Some of the more lasting tactics for reducing accounts receivable include simplifying payment terms, segmenting customers based on strategic value and risk, and setting up a rapid dispute resolution procedure. (See box, page 4, "Core Tactics for Improving Working Capital.")

One tactic that many companies overlook when seeking to optimize working capital is the use of incentive pay systems. Having a portion of compensation tied to variable pay that is aligned with company performance objectives is a common success factor cited by APQC benchmarking program participants. Roughly half of companies use some form of performance-based pay; at the top end of the scale, almost two-thirds of executives' annual salaries are linked to performance.

APQC has long advocated a disciplined approach to performance measurement and process management that focuses on sustainable improvements to drive long-term competitive advantage. We have found that identifying and implementing best practices reduces costs, eliminates errors, and improves cycle times in ways that directly benefit customers, ways that they tend to remember, which is critical in this age of fleeting customer loyalty. The gaps between high performers and low performers can be startling.

### PICKING UP THE BILLS

In addition to the 15-day accounts receivable advantage that top performers enjoy, they also generate billing data twice as fast as the median performance level (one day vs. two days for the median and a woeful six days for the bottom quartile). On the efficiency front, it costs top performers less than half as much to invoice customers (\$0.71 vs. a median of \$2.00 per invoice). Being able to leverage such advantages is why streamlining invoicing and accounts receivable processes, then stabilizing and maintaining those processes, must become a top priority for finance managers.



## PUT WORKING CAPITAL BACK TO WORK *(continued)*

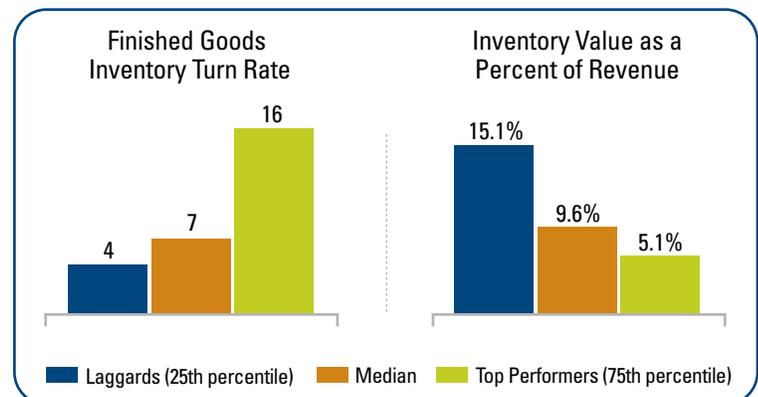
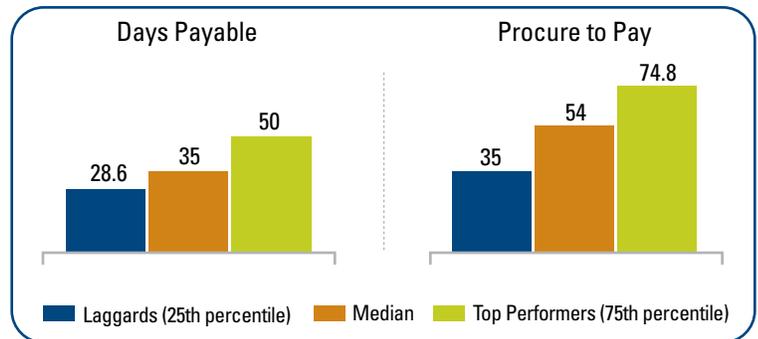
Longer payment cycles are one of the first signs that a company is hurting for cash. At the high end of the scale, this means 50 days of accounts payable and 75 days from the issuance of the initial purchase order to payment. Stretching accounts payable across the board won't create any lasting improvement in working capital. What it will do is strain supplier relations and distract employees who have to handle the deluge of collection calls. When there's a squeeze, negotiating longer terms with a few select partners can provide some breathing room. In the longer term, negotiating price discounts in return for prompt and guaranteed payment (30 days or less) can be a win-win for a company and its suppliers.

### WHAT YOU NEED, NOTHING MORE

From unscheduled sales promotions to raw-material shortages, many factors impact customer demand and, subsequently, inventory levels. In the area of inventory management, top performers reap the operational benefits of having lower storage space requirements and a lower risk of product obsolescence because they are able to turn their finished goods inventory more than twice as fast (16 turns) as the typical company (seven turns) and four times faster than companies in the bottom quartile (four turns). They also have less capital tied up in inventory, reporting a total inventory value of 5.1 percent of revenue, compared to the median inventory value of 9.6 percent of revenue and 15.1 percent of revenue for the bottom quartile. For the \$30.7 billion company on the *Fortune* Global 500, that's a \$1.4 billion working capital advantage.

How do they do it? Mostly by aligning production with actual customer demand and setting safety stock levels according to rigorous sales forecasts rather than arbitrary comfort zones. Leading companies will deploy cross-functional teams from procurement, operations, and finance who track inventory levels on a weekly basis to determine what to make, what to buy, and when to buy it. Analyzing the demand volume and variability by product segment, and then categorizing products as make-to-order or make-to-stock according to actual demand levels, allows production processes to be more predictable and responsive. Adjusting order policies—lowering minimum quantities, for example—can further smooth out demand.

Top performers forecast with precision and respond more quickly to unexpected events. We've repeatedly found that companies that have deployed some form of collaborative planning process for sales and operations report superior levels of order fulfillment and customer satisfaction, as well as lower inventory requirements. It's amazing how much finger pointing is avoided and how much faster problems are resolved when people know one another and communicate regularly.



## PUT WORKING CAPITAL BACK TO WORK *(continued)*

Rolling forecasts linked to current market conditions—not wild guesses made the previous fall—are another best practice used by top performers to link production activity to actual demand.<sup>2</sup> The ability to complete financial forecasts more quickly (four days for top performers vs. 10 days for the typical company) further increases the likelihood that those forecasts will be accurate, which encourages stakeholders to trust the numbers and not stockpile inventory just in case.

### WORKING CAPITAL WORKOUT

Corporations have billions of dollars tied up in working capital that could be put to work to grow the business or improve shareholder returns. Like every effort designed to move a company toward the upper end of the performance curve, releasing that cash comes down to leadership and execution. On the strength of their ability to navigate internal politics, the most successful finance managers are able to get sales, operations, finance, and customer service to stop playing short-term accounting shell games, work together to reduce working capital, and make those improvements stick.

#### CORE TACTICS FOR IMPROVING WORKING CAPITAL

- Report and emphasize cash-related metrics (days sales outstanding, inventory turns, etc.).
- Optimize the entire customer order-to-cash process.
- Reduce accounts receivable delays, complexity, and errors.
- Simplify payment terms.
- Segment customers by size, risk, and strategic value.
- Speed billing processes and reduce invoicing errors (consider electronic invoicing and payment tools).
- Communicate collection issues and speed dispute resolution.
- Review accounts payable policies for opportunities to stretch payment terms without damaging supplier relations.
- Improve supply chain visibility and agility.
- Adopt some form of dynamic forecasting and responsive inventory management, including cross-functional sales and operations planning.
- Optimize spare-parts inventory.

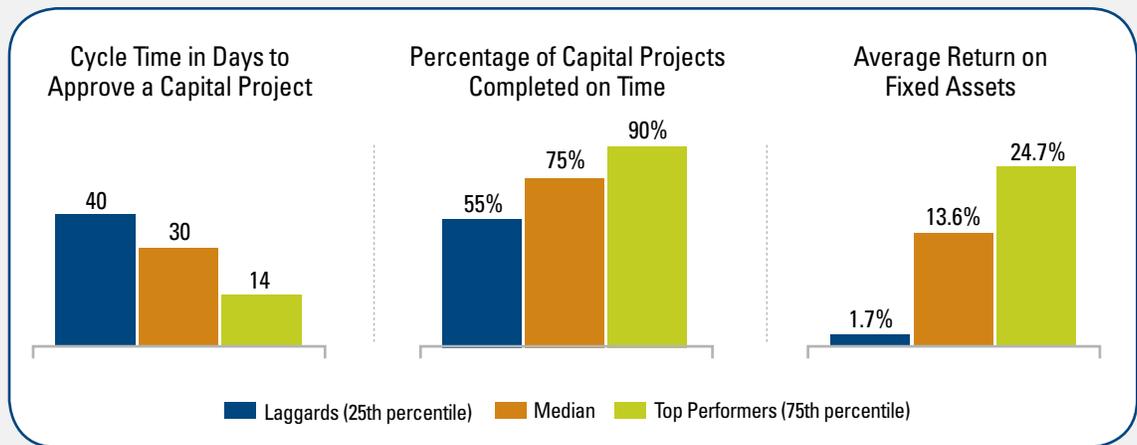
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<sup>2</sup>APQC. by the numbers: Finance. APQC Publications, 2006.

### THE FLIP SIDE OF THE CREDIT CRISIS

Because credit ratings are based on cash flow analysis, in addition to increasing the availability of internal funding, effective management of working capital can create what the economists describe as a “virtuous circle,” also known as a positive feedback loop. When credit markets are tight, superior cash flow makes it easier to get financing. Companies that can access capital more quickly at better terms can take advantage of opportunities faster and leverage them more fully, thereby delivering superior returns, which starts the cycle over again.

That’s the theory anyway. Here are some numbers to back it up. Top performers move fast. On average, they will analyze and approve capital investments within two weeks—twice as fast as the typical company. With all the issues and delays that can pop up during construction, equipment installation, and startup, the typical company will complete 75 percent of capital projects on time. Top performers do much better than that. They manage to get 90 percent of such projects up and running on time, which puts them that much further ahead when it comes to hitting ROI projections.



#### RELATED RESEARCH

- Open Standards Benchmarking Collaborative<sup>SM</sup> (OSBC): Financial Management, Human Capital Management, Supply Chain Management
- *by the numbers: Finance*
- *by the numbers: Accounting*
- *Blueprint for Success: Procurement*

## PUT WORKING CAPITAL BACK TO WORK *(continued)*

### ABOUT THE AUTHOR

Lisa Higgins serves as APQC's Chief Operating Officer and is responsible for the operations and financial success of the organization. In her 15 years with APQC, Lisa has led several departments and initiatives including the Custom Solutions Group, which is responsible for delivering knowledge management engagements, conducting custom benchmarking studies, and providing advisory services. She also served as director of benchmarking services and oversaw the delivery of more than 500 benchmarking and best-practice research studies for clients worldwide. Lisa is a frequent conference speaker and author on best practices and benchmarking topics with a special emphasis on financial management.

### ABOUT APQC

APQC is a member-based nonprofit founded in 1977 that currently serves more than 500 organizations worldwide. A global resource for process and performance improvement, APQC discovers improvement methods, identifies benchmarks and best practices, disseminates findings, and connects individuals.

Leading companies around the world use the Open Standards Benchmarking Collaborative<sup>SM</sup> (OSBC) research to benchmark themselves against their competitors and compare the performances of internal business units. APQC is continually renewing and expanding the OSBC database. Today it contains hundreds of measures and thousands of data points from over 7,000 organizations.

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