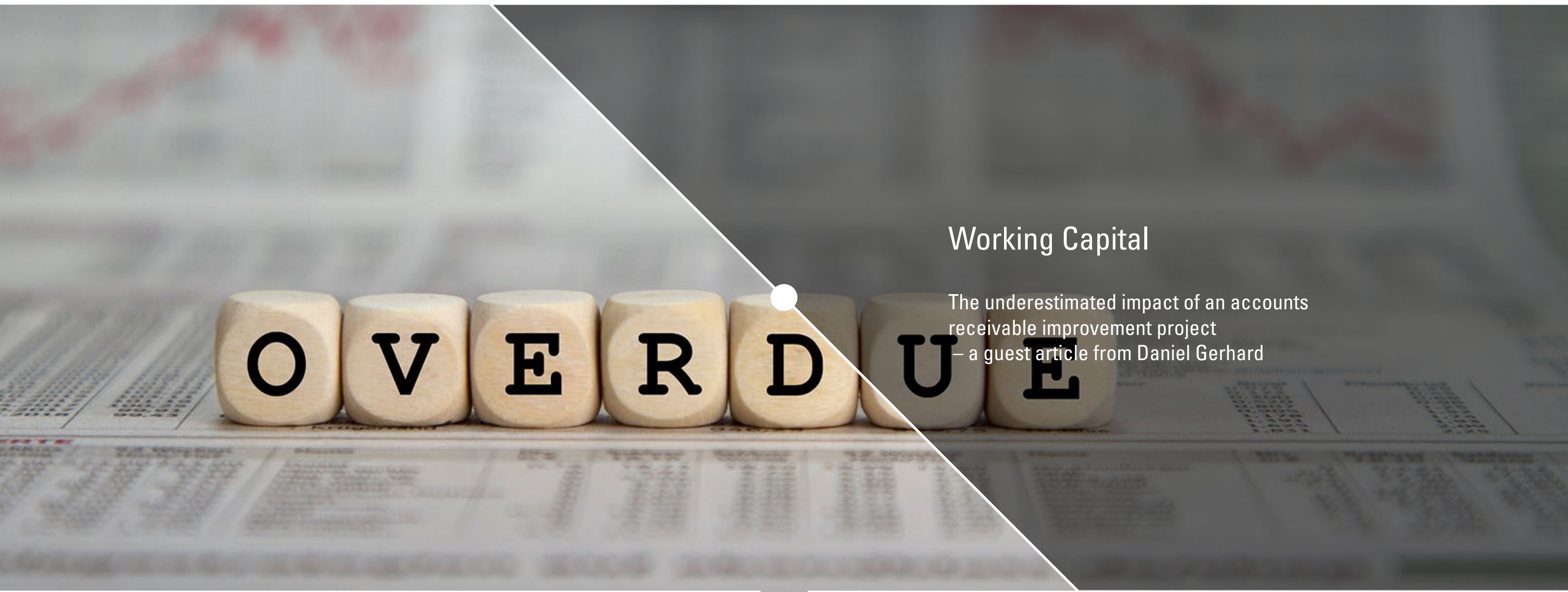

Working Capital

The underestimated impact of an accounts receivable improvement project
– a guest article from Daniel Gerhard

Working Capital is the key indicator for capital tied up in the company, equivalent to the sum of accounts receivable and inventory, minus accounts payable. Most companies focus on inventory management to control Working Capital levels, while accounts payable is often difficult to influence due to supplier pressure. However, significant potential for improvement lies within accounts receivable management, which is often neglected by companies. Key to success is the improvement of collections and dispute resolution cycles. To achieve this, I have developed an innovative and proven three-dimensional customer segmentation matrix approach that delivers significantly better results when targeting tied-up capital reduction.

GOALS OF IMPROVED WORKING CAPITAL MANAGEMENT

Working Capital represents tied-up capital and, therefore, financial risk, especially with regards to accounts receivable. A reduction of Working Capital has the potential to free up cash for investments and, at the same time, particularly for accounts receivable, minimizes the risk of bad debt and, eventually, costly write-offs. Moreover, when managed properly, it educates customers about committed and reliable payment behavior.

Sophisticated Working Capital management enhances detection and reduction of mismanagement in any of the underlying processes, and thereby increases profit margins. Working Capital improvement has three goals: firstly, to reduce accounts receivable to the lowest level possible, which is mainly determined by the standard payment terms of the industry; secondly, to manage stock at a maximum service level at minimum cost; and thirdly, to increase payment terms with suppliers to delay cash outflows. At the same time, it is critical to avoid damaging the company's key performance indicators (KPIs), such as sales, while optimizing Working Capital.

We often encounter similar shortcomings in accounts receivable among our clients. These include the tendency to have numerous payment terms in use, even multiple terms for the same customer. Poor communication between Headquarter and Business Unit is another common problem. Also, companies often have unnecessary and expensive credit insurances in place and fail to formalize level settings and authorization while setting initial credit limits – mostly for new customers.

Companies often lavishly allow high levels of overdue debt and do not have days of sales outstanding (DSO) targeting linked to cash targeting. Ownership of key processes is often unclear or disputes are predominately solved by issuing a credit note – a very costly procedure, which can consume the entire profit margin. Overall, key process managers often do not measure or do not know current DSO and best possible DSO (BPDSO) levels.

OPTIMIZATION TOOL AND METHODOLOGY FOR ACCOUNTS RECEIVABLE

Related to these shortcomings, some companies attempt to address these issues with a two-dimensional customer segmentation process. However, the majority of these companies fail to include the right analyses and metrics and, therefore, do not realize the benefit from this process. The better approach is demonstrated by the enhanced customer segmentation cube that I developed. The cube includes three dimensions: average overdue, customer size and customer's strategic importance.

Figure 1: Illustrative cube for customer segmentation, selecting high-impact customers

Segmenting customers by a third dimension makes the process more sensitive for identifying 'bad payers' who offer the highest potential for freeing locked-up cash. The customer segmentation cube permits the development and application of highly differentiated collection strategies, individually tailored to each group of customers. If applicable, further customer segmentation categories can be added.

METHODS FOR REDUCING DSO

Accounts receivable improvement requires cross-functional commitment and continuous communication to achieve sustainable change, including: new customer set up, sales and contract management, risk management, order processing and billing, cash targeting and collection management, cash allocation, and dispute and deduction management.

More specifically, methods primarily applied to reduce disputed DSO include sophisticated customer segmentation, state-of-the-art dispute management (including a proactivity approach) and a root cause analysis with cause elimination. Methods to decrease 'allocation', 'past due' and 'within tolerance' DSO limits include account cleaning, contract management and a sophisticated collection process management accompanied by the right set of tools and metrics. Finally, a standardization of payment terms can be applied to reduce DSO in all new contracts. Therefore, DSO can be significantly reduced, with overdues often cut in half in the short to medium term, to deliver substantial benefits.

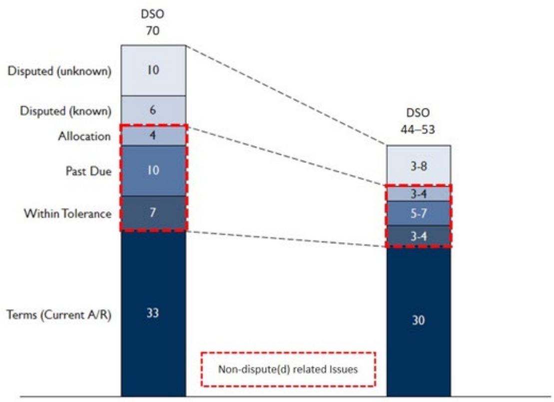

Figure 2: Example of DSO before and after the professional reduction project

MEASURING SUCCESS FOR ACCOUNTS RECEIVABLE

DSO as a KPI is an important metric to measure the success of an accounts receivable improvement project and to prove its independence from sales. Statistically, about one third of DSO improvements result from payment term standardization and about two thirds from improved collection strategies.

To ensure a smooth transition to new processes and methodologies, improvement projects need to be well prepared and professionally implemented. Miscommunication with customers and incomplete or disjointed implementations can jeopardize customer relationships and put sales performance at risk. Bearing in mind that businesses are highly diverse, every company requires a specially tailored and customized approach to Working Capital optimization. 'Off the shelf' solutions are a dangerous undertaking.

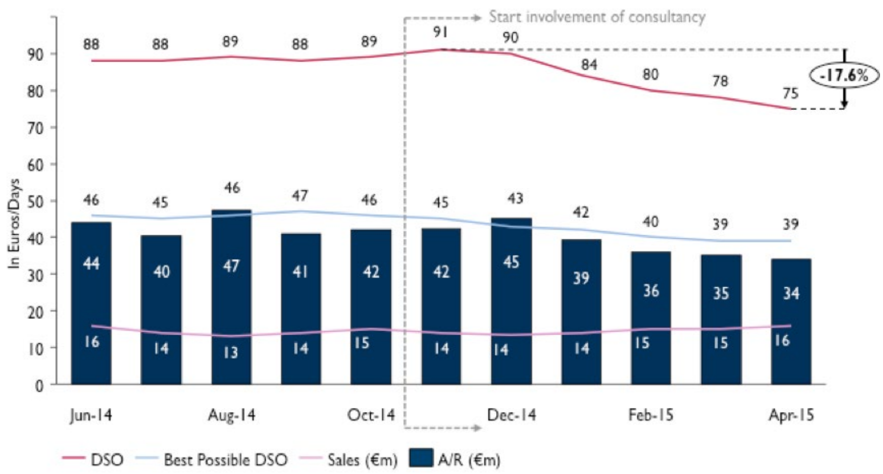

Figure 3: Example of DSO development before and after the consultancy project

CONCLUSION

Working Capital projects are critical for unfreezing cash, which allows companies to address their most urgent needs, such as making investments, guaranteeing production flow, improving customer satisfaction, managing bad debt and avoiding major write-offs. The latter is becoming more and more important in a globalized business environment, particularly in times of crisis and increasing numbers of customer bankruptcies.

The best starting point is yet again accounts receivable management, which frees up cash relatively quickly. Nonetheless, a simultaneous accounts payable and inventory improvement project is recommended to improve both supplier management and production flow.

My experience is that only a holistic approach covering all three Working Capital-related areas can unveil the complete list of a client's shortcomings, often linked to each other. As mentioned, these shortcomings, and the excessive issuing of credit notes, can cause significant losses and, hence, a reduction of the company's overall profitability.