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Working Capital Management:

Optimization & Alignment

The CFO's Guide for Improving WCM

Contents

Introduction

Whether small or large, all organizations have goals that require capital. For some, meeting payroll consistently is a matter of concern. For others, payroll is easily managed, but more working capital could fund receivables, support making a strategic investment, and power growth.

Wherever your company finds itself, managing working capital efficiently can make a significant difference in the liquidity available to further organizational goals. In the process of optimizing it, your company is likely to eliminate hindrances to revenue, increase efficiency, bring siloed areas into proper alignment, and even improve relationships with suppliers or customers. That said, working capital management can be a complicated and difficult topic for many organizations to approach and address.

Working capital initiatives cut across multiple departments and require rooting out competing KPIs. The number of moving parts impacting and impacted by it makes it rather overwhelming when one begins trying to gracefully optimize it without overcorrecting or creating unintended consequences. This multi-factorial element also makes it difficult to communicate with others about what is important and what needs to be done. To top it off, different parts of the organization define working capital differently.

Nonetheless, working capital management is doable and entirely worth the effort. With a few key pieces in place and a few foundational concepts communicated, the path becomes much clearer. The aim of this mini eBook is to help the office of the CFO, treasury, and any group or individual hoping to improve working capital to form a foundational understanding of working capital management, its proper goals, and key steps to take to bring your organization into a position of robust liquidity, efficiency, and flexibility.

In these pages, you will find the different definitions of working capital and their purposes; the appropriate aims of a working capital management program contrasted with the red herrings; stories that demonstrate working capital issues and solutions; and leading practices and necessary steps. We hope you find guidance in this mini eBook that helps you lead your organization into a thriving state of efficiency and excellence.

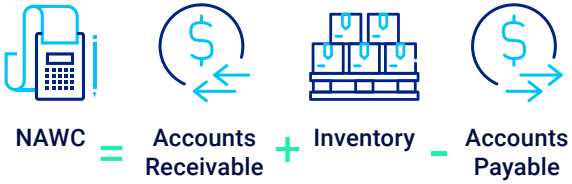
> Working capital management is doable and entirely worth the effort. With a few key pieces in place and a few foundational concepts communicated, the path becomes much clearer.

Working Capital Foundations

Defining Working Capital

TRADITIONAL / ACCOUNTING

NET ADJUSTED WORKING CAPITAL (NAWC)



Various areas within organizations define working capital differently. This can frustrate initiatives before they even begin and can plague efforts persistently if not understood and dealt with appropriately.

There are two primary definitions of working capital used in organizations today. The first is the **traditional** or **"accounting"** definition, expressed in the following formula: **"working capital = current assets - current liabilities."** This definition has several advantages. It is easy to calculate with no information beyond what you find on a balance sheet, and it is a simple way to gauge the organization's ability to meet current obligations — a vital thing to measure.

While important, common, and easy to calculate, this definition of working capital is not the one we are focused on for optimizing business and capital efficiency. Instead, we will be using the **"net adjusted working capital" (NAWC)** definition expressed in this formula: **"NAWC = accounts receivable + inventory - accounts payable."** Throughout the following pages, "working capital" refers to the NAWC definition, not the traditional definition.

It is important to be clear on this: the NAWC definition is not better than the traditional definition, and the traditional definition should not be considered as wrong or unhelpful. After all, meeting current obligations is not something to be downplayed, and the traditional definition helps ensure that this can be done. However, when seeking to optimize capital and operational efficiency, the NAWC definition is most relevant.

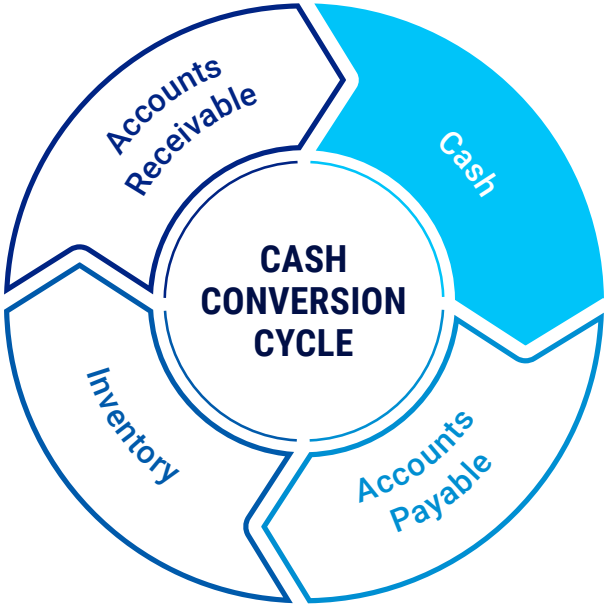
Since working capital initiatives cut across quite a few areas within the company, they require a good deal of communication with those from other departments and from completely different backgrounds from your own. Many of them may hear certain words and think of something quite different from what you mean. Keep in mind the backgrounds and contexts of those you speak with and try to clarify terms such as working capital that may otherwise produce confusion.

Capital and the Cash Conversion Cycle

Capital is one of the most important and easily mismanaged resources a company has. It ties into basically every other resource, influencing and influenced by the availability and use of everything from manpower to time and inventory. If an organization is to thrive, its capital must be well-managed, and the larger and more complex that organization becomes, the more vital intentional management of working capital in particular becomes.

Working capital, by the net adjusted definition, runs in parallel to the cash conversion cycle (CCC). This cycle essentially tracks how many days it takes an organization to convert inventory back into capital that can be used to buy more inventory. As such, it is a measure of efficiency.

The CCC depends primarily on three things: how long inventory sits idle before selling (days inventory outstanding or "DIO"); how much time passes between a sale and the receipt of usable cash (days sales outstanding or "DSO"); and how much times passes between the company incurring an expense and meeting that obligation (days payables outstanding or "DPO"). Adjusting any of these three metrics will impact the CCC, and the CCC, as an indication of how quickly capital is freed from the inventory investment, impacts working capital.



Don't Minimize, Don't Maximize, but Optimize

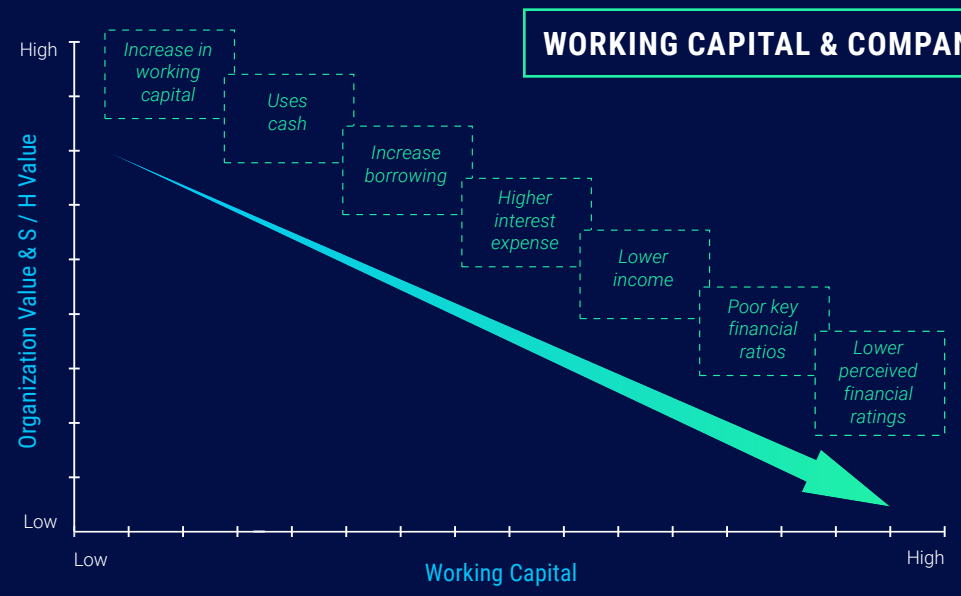
It is tempting to want a quick and easy goal to focus on with each of these measurements. For example, minimizing the CCC would be a simple goal — as long as it's being reduced, the goal is being met. Certainly, no one wants an unnecessarily long CCC. However, thinking about either the CCC or working capital in terms of minimizing or maximizing has a tendency to pull various operations off course and sow confusion, problems, and conflict.

Since working capital is so intricately connected with multiple areas and measurements, adjusting it properly requires careful consideration: What impacts will the changes you're considering have across the organization? Which pieces should be adjusted to get the result you need, and will adjusting those pieces have any unintended consequences?

Changes made based on such a narrow focus as minimizing or maximizing a metric are often problematic, especially in the complex and multi-factorial area of working capital. Instead, the proper goal of a working capital management program is *optimization.*

Optimization walks the line of "enough, but not too much" or "as little as each factor allows." Too little working capital, and you cannot fund your business, but too much working capital can adversely impact organizational value. A thoughtfully run working capital management program finds the sweet spot in between while considering all the factors and impacts.

Note that discussions surrounding the proper goals of your working capital program may be a time when being clear on the different definitions is particularly vital. By accounting's traditional definition, more working capital is usually correlated to a more robust financial position. It may be necessary to explain in detail that this is an area where traditional working capital and NAWC differ meaningfully: NAWC has a cost, and increasing it can lead to a draw on cash, increased borrowing, higher interest expense, lower revenue, and finally, poor key financial ratios and a lower perceived financial rating.



	Accounts Receivable
+	Inventory
-	Accounts Payable
	Net Adjusted Working Capital

* Jeffery, C. A. (2009). *The Strategic Treasurer: A Partnership for Corporate Growth.* John Wiley & Sons, Inc.

THREE COMPANIES ARE ALL COMPETING TO SELL YOU THE SAME TYPE OF PRODUCT:

COMPANY **A**

has low inventory and can't give you the product you need for five days.

COMPANY **B**

purchased a year's worth of inventory on sale last month and can easily sell you the product today.

COMPANY **C**

has enough inventory in stock to sell you the product today, but they don't have significantly more in stock than they can sell soon.

Stories on Working Capital: Inventory, AR, and AP

Inventory

Which of the companies in the diagram to the left comes out ahead? Company A's low inventory probably loses them the sale because you want the product sooner rather than later. Company B might make the sale, but they have no competitive advantage over Company C, and their year's worth of inventory stores have tied up a massive amount of capital, putting a strain on their organization. Company C has hit the sweet spot and is likely to fare best.

When setting about to optimize your working capital, inventory will prove a vital area for ensuring that goals are appropriately aligned and are not too focused on minimizing, maximizing, or on any other narrow metric. Sales, revenue, capital needs, and many other considerations need to be taken into account as you approach inventory and seek to optimize it and, through it, working capital.

That being the case, inventory management is complicated and difficult to manage properly, especially during times of global upheaval and supply chain difficulties. While quite important, it may not always be the area to tackle first in your working capital program.

Accounts Receivable:

If minimizing working capital were the real goal of your program, AR would be an easy place to accomplish this. Stop extending credit, minimize AR, and suddenly your working capital would be quite low. Your company would not have to wait for payment and would have rapid access to cash — that is, until many of your customers left for your competitors who were still extending credit. Both over- and under-extension of credit can damage the company in their own ways.

On the other hand, there are some reasons for extended DSO that a working capital management program should look to eliminate. Inefficient and error-prone processes result in low-profile but significant costs. If a company takes weeks to get an invoice out, and then many invoices every month are returned as erroneous and have to be corrected and re-sent, this creates a delay in converting receivables to cash. Unlike the extension of credit, inefficiencies do not have any benefits to make them worthwhile to your organization.

Depending on your company, there may be a great deal of work to be done in AR in order to optimize your working capital. As always, keep in mind the chain reactions of each potential change, and try to help align the goals of the area with *optimization.*

CONSEQUENCES OF NARROW GOALS

Minimize Inventory → • **Sales Go Down**

Minimize Accounts Receivables → • **Uncompetitive** • **Loss of Profit & Sales**

Accounts Payable:

AP is often the best area to begin with in a working capital program. There is often much that can be done to infuse flexibility into the cash conversion cycle through improving the efficiency of payments. In fact, sometimes the efficiency that can be achieved in AP is powerful enough to cause its own set of problems if not adjusted for properly.

Consider the following story. A company's invoice approval process took 35 days. Since their payment terms with their vendors were set at 30 days, payments were always made immediately after approval and were still late. Realizing that they had to fix this problem first in order to make any progress on working capital issues, they addressed the invoice approval delays thoroughly.

Their efforts were extremely effective. They condensed their approval process time down from 35 to 10 days. However, they initially failed to adjust properly for this and continued to pay all invoices immediately after approval — 20 days early. The problem was identified quickly, as the resulting cash crunch was quite large enough to draw attention, and the AP process was modified to delay payment for the length of the terms unless there were reasons to do otherwise.

EFFICIENCY & FLEXIBILITY

What this company initially failed to account for was the fact that efficiency is not simply about speeding a process up as much as possible. It's about having the option to pay whenever is best, which — if you aren't already late — may not be immediately.

Their efforts to remove the inefficiencies from their approval process were not wasted, as this offered the company the flexibility to choose to pay vendors anytime after the 10 days of approval. Having the efficiency to choose when to pay meant that the organization had room to adjust working capital as needed and easily calibrate for changing liquidity requirements as time went by. The same principle of efficiency leading to flexibility, which in turn leads to more room for working capital adjustments, applies broadly across the CCC, but it is perhaps most obvious in AP.

Tip: Thinking of SCF or other supply chain programs?

CHECK YOUR EFFICIENCY FIRST.

Those hoping to improve their working capital may also be looking at supply chain finance (SCF) and similar programs. Survey data suggests that for many buyers, getting their suppliers to participate is the most pivotal factor in their program's success.[1]

Multiple factors impact supplier participation, from ease of use to onboarding fees, but one that may be easily overlooked is your company's credibility with suppliers. Inefficiencies in your processes damage your credibility, especially (but not only) if those inefficiencies have led to late payments. Lower credibility leads to less motivation to participate in your programs. If you're considering an initiative that would rely on supplier participation, increasing your efficiency can demonstrate to them that your company has its processes in good working order. This can make them more comfortable trusting your program.

[1] *2019 Supply Chain Finance Survey.*

Implications

Misalignment

> There are many motivations to pay.

A treasury consultant, while onsite with a client, was discussing matters while standing behind an employee making payments. He noticed, as they talked, that the AP employee went into the system, overrode a payment date that had been set for 15 days in the future, and made a massive vendor payment immediately.

When asked what he was doing, the employee explained that the vendor had once been paid late, and this had caused quite an uproar. He didn't want to be yelled at again, so now he paid the vendor 15 days early to be on the safe side.

By making this major payment 15 days ahead of schedule and reducing their available capital unnecessarily, the employee was unwittingly costing the company multiple times the value of his own salary every year.

At another company, AP was found to be keeping a vendor paid up in full every month not due to payment terms or strategic reasons, but because the vendor provided a pizza party to the accounts payable group every time they paid off their full balance.

There are many motivations to pay. While pizza parties and avoiding getting yelled at are relatable motives, they do not reflect alignment of an area with other areas and broader organizational goals — such as optimizing working capital.

In both of these cases, the companies were trying to manage their working capital well. They had policies and initiatives in place. This attention to working capital, however, did not flow down the line to key operations, and the organizations were opened up to costly misalignment between areas and goals.

The earlier example of the AP department that continued paying immediately after approvals despite having reduced their approval process from 35 days to 10 also demonstrates misalignment with the goals. Their project to reduce the approval time was an excellent move for working capital management, but their initial use of the project showed a narrow, process-driven, "minimizing" focus rather than a broad optimization focus that considered working capital and other organizational goals.

When misaligned, each area focuses on the metrics that seem important to them. Without realizing it, they often narrow in on items that are minutiae to the organization at large. This leads to competing KPIs, siloed information and processes, and suboptimal resource use.

To Alignment

Alignment refers to corporate-wide understanding and optimization at the macro level. It means that the company's most important goals are deeply ingrained not just among top-level executives, but among each department. The needs of other areas are known and considered, and KPIs are reconciled and relevant.

This is clearly a better situation for an organization in many ways, working capital included, but how can the office of the CFO and others hoping to optimize working capital move their companies from misalignment to alignment? After all, the departments involved in the CCC each have very different internal goals and are prone to competing KPIs. Getting them all onto the same page is hardly a walk in the park, but it is a necessary first step if better working capital management is your goal.

If you don't yet have one, establishing a working capital council is a leading practice for accomplishing this somewhat daunting task. The council brings all the stakeholders and decision-makers for working capital into the same room and helps instill alignment and proper focus.

Treasury often heads up this council, with those in attendance including various groups, from AP and AR to legal and accounting. Exactly what areas need to be involved will depend on your organization. What's important is that the primary parties who need to get onto the same page for working capital are all in that room.

THE COUNCIL SHOULD BEGIN WITH THE FOLLOWING THREE GOALS:

1. Eliminate Misalignment: The working capital council is a place for each group to develop understanding of other areas. Once each group's needs are understood, the organization's working capital needs are understood (at least generally if not nailed down in detail yet), and the needs of any parties such as external partners are understood, competing KPIs can be identified and eliminated.

2. Align: KPIs, however, exist for a reason, and simply eliminating KPIs would be — in keeping with the theme — too narrow of a focus. Now that the groups have broken out of their misaligned metrics, they need new, aligned metrics. New KPIs should be established that help align each group with organizational needs and goals.

3. Establish Objectives: The development of these new KPIs can then lead into the development of specific objectives for working capital initiatives. At this point, seek to create efficiency in any CCC areas (again, AP is often a good place to start) where flexibility is limited or inefficiencies are causing problems. With flexibility in play, your council can then discuss and implement any other initiatives and adjustments to optimize your organization's working capital.

At this point, your company is likely seeing significant improvements. However, don't disband your working capital council as soon as things improve. As your organization grows and the environment changes, your company's working capital needs and the factors playing upon it may shift.

Your council should keep track of the effectiveness of various initiatives and should continue to meet periodically (most meet monthly or quarterly) to discuss what is and isn't working. Make sure the council is apprised of relevant organizational plans and goals that may impact working capital or may be supported by adjustments in working capital management. Using the flexibility that is now available thanks to increased efficiency, the council can fine-tune objectives and programs as needed to maintain a well-aligned working capital management program that supports your organization's current and future needs and goals.

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