Seven Strategic Approaches to Cash Flow Control and Management

Jason Sweatt, CTP | Senior Vice President, Liquidity & Deposits Group Manager

Cash flow management may seem like a moving target because it is. Balancing the independent factors affecting cash flow coupled with natural fluctuations sometimes make it difficult to steady the target. For improved forecasting and control, however, there are practical approaches to cash flow management that will help to bridge the gaps more predictably. Increasing internal controls and external pressures on cash flow require disciplined fiscal methodologies.

1. Introduction: Taking a Holistic Approach

It’s Finance 101: Cash flow is the lifeblood of a business. But for something so crucial to a company’s success, it’s an issue that can be remarkably difficult to get a handle on. That’s partly a factor of size: Researchers from the Wharton School of Business, the University of Texas, and the University of Georgia found that a substantial portion of U.S. companies’ assets—a median of 28 percent—are tied up in net operating working capital. But it is also because cash flow is a process with many interconnected drivers and levers, some within the finance department, but most beyond it, in sales, purchasing, and operations. What’s needed, then, is a holistic approach to cash management, in which different functional areas share information freely and work together to strike the right balance.

As the economy continues its halting recovery, companies are taking to heart lessons learned during the times of contracting sales and shrinking margins. They’re maintaining vigilance over their cash positions even as they look toward increasing investment in future growth, with good reason. A recent survey by CFO Research Services found that 62 percent of mid-market companies are experiencing more downward price pressure now than they were five years ago, making fiscal discipline more important than ever.

Keeping an eye on free cash flow and working capital can pay off not only in reduced risk, but significant shareholder value as well. The Wharton study suggests that one dollar tied up in net operating capital is worth less (52 cents on average) for shareholders than one dollar held in cash that can be invested in growing a business.

2. A Strategic Approach

The discipline in working capital management instilled during the recession led to more efficient operations and significant gains in resource productivity, so

continued
CFOs are not about to allow themselves to slip back into bad habits. “Caution has been the overwhelming theme as we emerge from the ‘Great Recession,’” says Jason Sweatt, senior vice president, liquidity & deposits group manager at Regions Bank. “Companies have become more rigorous in maximizing cash flow and keep a very close eye on every penny.” As a result, businesses of every size are taking a “back to basics approach” to cash-flow management that begins with a concise set of metrics communicated across the organization, informed and up-to-date forecasts of supplier payments, client demand and working-capital needs, providing end-to-end visibility across the cash-conversion cycle.

This strategic approach contrasts sharply with short-term emergency measures such as delaying payments or intermittently stepping up collection efforts, which can be detrimental to relationships with vendors and clients alike. Vendors may adjust pricing to reflect your long-term payment history, while poorly managed collections can alienate clients.

“Strategically managing cash flow means to have an understanding of the entire cash-conversion cycle,” Sweatt explains. “Once a company understands its receivables, its payables, how much cash is tied up in inventory, and the number of days cash is tied up, it can begin to make decisions about whether to pay down debt or invest excess funds.” Cash-flow management, then, is first and foremost, a function of foresight, in which projections are part of the budgetary process.

Performing a cash-flow sensitivity analysis can help you forecast your cash situation and address any potential shortfalls before they happen. To create a cash-flow-sensitivity analysis, simply subtract all expected outflows (vendor and loan payments, capital expenditures) from expected inflows (client receipts, loan proceeds, etc.) in a given period. Prepare the most likely scenario as a base case, as well as best- and worst-case scenarios to develop a clearer sense of what might lie ahead. If you anticipate a shortfall, you can draw from an investment savings account or line of credit. If there’s a surplus on the horizon, you can pay down debt or make strategic investments.

A cash-flow sensitivity analysis is also an opportunity to review your cash-conversion cycle—how quickly you’re converting inventory into sales and sales into cash. Let’s take a closer look at the cash-conversion cycle and how companies can improve cash flow by shortening the time between cash outlays and inflows, reducing working-capital needs, and freeing up cash locked in payables, inventory, and receivables as well as operational inefficiencies.

3. Managing Payables

Cash-flow management is nothing if not a balancing act. At each stage, companies must minimize working capital requirements while optimizing relationships with critical stakeholders, including vendors, clients, and creditors. In the case of payables, this means maximizing the period from purchase to payment while meeting vendor terms and maintaining appropriate inventory levels. “Payables are typically where we find the greatest untapped source of cash among midsized companies,” says Sweatt, echoing a common theme among experts.

When it comes to payables, the metric to keep an eye on is Days Payables Outstanding (DPO), calculated as Payables x Days ÷ Cost of Goods Sold. To maximize DPO, companies can either increase the time they take to pay and/or decrease the cost. To increase time, you can rely on trade terms, or, as is increasingly common, use a purchasing card to extend payment even further. Purchasing cards, ideal for high-volume, low-dollar transactions, have the added advantage of simplifying payment and reducing the number of cash outlays each month. To lower cost, you could take advantage of early payment discounts, which can be more than meets the eye: a 2 percent, 10 net, 30

continued
term, for instance, is equivalent to about a 36 percent APR. It can be helpful, then, to establish a threshold rate at which you’d opt for such a discount—typically 18 percent.

Your relationship with vendors, though, is more than simple math. Experts strongly recommend working with vendors as strategic partners to develop win-win cash-flow solutions with each one. When working with midsized clients, Chris Gattis, principal of Huntsville, AL-based consultancy Blue Point Strategies, begins by determining the strategic importance of and volume of expenses, and hence suppliers. “What are the 20 percent of things we spend money on that represent 80 percent of the money? Let’s start with the biggest one,” he says. As a result of such an analysis, you may be able to segment your suppliers by volume and strategic value, which in turn helps determine how to maximize DPO. “You would treat each of these big vendor categories differently,” Gattis explains. “What’s the standard way to do business in this category? How much leverage do you have to improve price or terms?”

Once you’ve segmented your vendors, you can work toward implementing a payment policy optimized for each, (e.g., terms extension for strategic suppliers, early payment discounts for smaller accounts, and purchasing-card settlement for non-strategic suppliers).

4. Managing Receivables

On the receivables side, of course, your priority is the reverse: you need to shorten the time from a client’s order to cash in the bank, or Days Sales Outstanding (DSO), calculated as Receivables \( \times \) Days \( \div \) Gross Sales.

And as with vendors, a strong relationship and open communication with clients are critical. “Relationships developed with clients can have a significant impact on cash-flow management,” Sweatt says. “How your clients pay affects the timeliness of getting the funds into the bank, so you should be looking for any way to speed this up, either through offering a payment term discount or by using bank products that can get payments collected faster,” such as electronic transfers including ACH or direct debit.

Communication begins with a clear credit policy, including written terms of trade and making sure both clients and internal stakeholders understand them. “Sometimes it’s a matter of reading your own contracts,” Gattis says, and following through on their terms, (e.g., by making sure credit limits haven’t been breached before any new orders are accepted). By keeping an eye on receivables aging, you’ll be able to respond quickly to issues before they become critical. Pay special attention to trends. If payment time is getting longer, it may be time to find out why, and work through any issues.

Clients, like vendors, come in all sizes and degrees of strategic importance. They may also vary by profitability. Large clients may command volume discounts that squeeze margins, so it is particularly important to examine the costs involved in acquiring and maintaining them. Take a look at how you’re allocating fixed costs, for instance, and determine if there is a reasonable basis to allocate them to clients or segments other than gross revenue. Examples might include sales commissions or technical support costs.

5. Managing Inventory

If your business holds inventory, you’re familiar with the dilemma of over-stocking “just in case” to meet unexpected client demand versus tying up cash resources in slow-moving stock. The metric to watch here is Days Inventory Outstanding (DIO), calculated as Inventory \( \times \) Days \( \div \) Cost of Goods Sold.

The absolute value of DIO can vary significantly from industry to industry—grocery items will turn over more quickly than fine jewelry, for instance—so
it is more important to track how these numbers change over time to discern broad trends. Again, segmenting inventory by strategic value (usually, but not exclusively, equivalent to volume) can help set priorities. “We generally categorize products using an A, B, C, D model,” Gattis explains. “‘A’ items are those with the highest frequency of sale,” and thus the ones that must be on hand at all times. This analysis will offer guidance in price negotiations as well as when to take advantage of bulk discounts.

When managing inventory, accurate and up-to-date forecasting is essential. And it’s not enough to focus on sales estimates, which can easily result in overstocking, but to incorporate data from all relevant segments, including supply-chain processes, manufacturing, distribution, and marketing.

6. Beyond the Finance Department

Gathering the intelligence to make sound cash-management decisions means reaching beyond the finance department into every aspect of the organization. It starts with a clear understanding of company strategy and values, and making everyone, from middle managers to front-line employees, aware of how their actions affect the company’s cash position. Take the example of online retailer Zappos.com. Well-known for its strategic emphasis on superior customer service, Zappos doesn’t rely on drop shipments to fulfill orders, instead maintaining a vast inventory to give it control over the entire customer experience. A case study performed by the American Productivity & Quality Center (APQC) showed how the company challenges itself to minimize its working capital while keeping inventory turning and maintaining its high level of customer service.

In the cross-functional model, “treasury operations are the hub of the entire organization responsible for cash management,” says Sweatt. Financial processes are streamlined and centralized, and functional areas communicate with the financial department as well as with each other to uncover efficiencies and manage problems. Information about working-capital drivers and client or vendor relationships flow from front-line employees and managers, while the finance department provides guidance and controls to effectively implement policy. To show how this works, Gattis offers the example of a tech company whose clients were balking at service bills. “It came down to how the front-line techs were estimating the jobs,” he says.

“They were overly optimistic, so that the final bill was out of line compared to client expectations.” As a result, clients were sometimes billed for repairs that exceeded the replacement value of the equipment itself. By re-aligning the process of generating work estimates, the company was able to reduce client dissatisfaction and lower the chance that a service invoice would be challenged.

7. Putting It on the Agenda

Keeping your finger on the pulse of cash flow isn’t a difficult process, but it often takes a back seat to other priorities until crisis strikes—at which point it may be too late. By taking a forward-looking, process-driven, strategic approach, managing cash flow can not only avert such a crisis, but provide a solid platform on which to build value and drive growth.

“Mid-sized companies typically have a number of opportunities to improve their cash flow,” says Sweatt. “If you haven’t historically had a routine for cash flow management, then the first step is regularly scheduling the basic analysis.”