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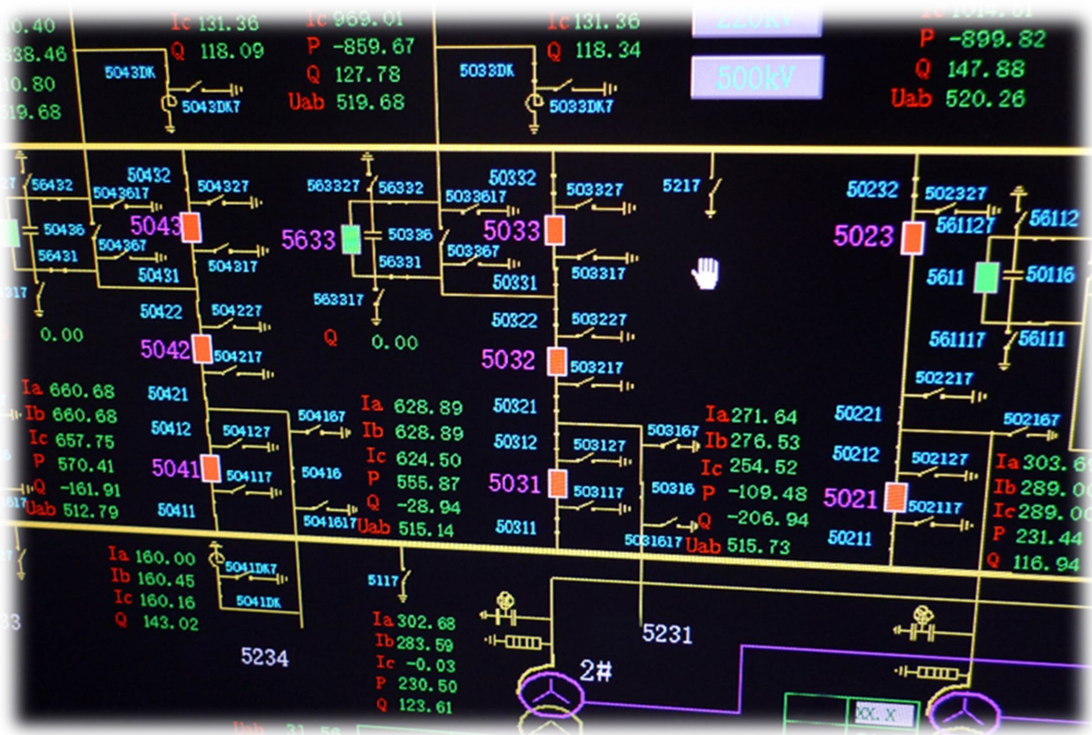

Optimize Working Capital to Strengthen Cash Positions

With a focused effort on sharpening working capital, organizations can tap into the most inexpensive investment capital available.

As economic uncertainty persists, a more proactive approach to optimizing work capital can help insulate an organization from certain risks—and it's more within senior management's control than revenue. An unprecedented period of growth over the past decade may have lulled some organizations into a sense of comfort about working capital, giving it perhaps less attention than revenue and profitability.

For those tasked with managing working capital, the Goldilocks principle may feel like a daily reality. If the company has too much working capital, cash may not be properly deployed to grow the business. If it has too little, creditors may question whether the company can meet its obligations. Balance between assets and liabilities needs to be just right, yet striking that balance can become more challenging amid uncertainty.

As such, determining optimal levels of working capital deserves the same level of executive focus and rigor as sales and revenue. It's not a one-time event to address a liquidity shortfall but an ongoing program to maximize availability of capital and shield against economic volatility.

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Benchmark Performance, Leverage Data

The first step in creating an optimal approach to working capital is to establish baseline performance against industry peers. This involves exploring good practices within an industry based on factors such as company size, lines of business, and business maturity. By identifying a leader in its industry, an organization can leverage its data against that baseline to assist in determining goals and objectives for an optimal working capital management program.

Baselining performance and aligning to it can also uncover new opportunities. The exercise can give C-suite executives a sense for how comparable industry peers access affordable capital, and it may lead to potential M&A opportunities.

What's more, an organization's own transactional data can provide important insights that can help when evaluating areas where current performance is not optimal or noncompliant with policies. Gathering and organizing that data, however, is typically a challenge. Data may be contained in disparate systems, and it may be unstructured, making analysis difficult.

Technologies such as data mining and AI can bridge multiple data sources and automate the simplification and summarization of transaction data. The added speed and insight can enable more efficient and effective diagnosis of obstacles to working capital processes, even helping to quantify and prioritize opportunities.

A deep-dive analysis of transaction-level data can facilitate a thorough exploration of root causes of cash warnings. This may provide valuable intelligence into each working capital cycle, which means the time required to convert net working capital into cash.

While applying analytical tools, organizations can also explore processes that underlie the working capital financial landscape. They may identify obstacles impeding collections, for example, and they can explore whether the problem lies in processes, people, technology, or external factors that may be difficult or impossible to control.

Measure to Manage

Ratios such as days sales outstanding (DSO), days payables outstanding, and days inventory outstanding provide useful information based on financial statement data regarding how an organization is managing its working capital. Not only can these ratios help flag potential problems, they also can uncover trends among customers, products, and markets that can support the development and execution of a working capital management strategy.

To serve as effective indicators, these basic metrics can be calculated and used appropriately based on what makes the most sense for a given organization. The data may need to be separated into relevant groupings, such as customer class or geography. If applied too broadly across a wide range of transactions, the information can flatten outliers and mask underlying issues.

More sophisticated working capital metrics might also be helpful, such as a collections effectiveness index, which is a calculation of a collection team's ability to retrieve an account receivable from a customer. This metric compares the amount that was collected in a given time period to the amount in receivables that was available for collection, which can support the identification of root causes.

Weighted average payment terms may also be important to calculate and analyze, as the different values and payment terms in invoices may render DSO inadequate as an indicator of how efficiently accounts receivable are transitioning into cash flow. Metrics such as weighted average terms (WAT), weighted average days to pay (WAP), and weighted average days outstanding (WAD) might be important to consider.

WAT calculates the average number of days allowed before a payment by a customer or to a vendor is due, factored according to invoice amounts. With some invoices due in 20 days, others in 30 or 40 days, such a metric provides a balanced view of aggregated, weighted contractual master terms with customers and vendors.

WAP represents the number of days a customer takes to pay or the number of days taken to pay a vendor, weighted by the payment amount. A comparison of WAT and WAP can provide insights into which customers typically pay late or which vendor payments typically are stretched.

WAD represents the average number of days an invoice has remained unpaid, weighted by dollar amount. Analyzing WAT, WAP, and WAD in tandem can provide insight into the average number of days an invoice is early or late and the number of days customers were given to pay compared with when they actually paid.

While it may be time-consuming at the outset to establish the systems and processes necessary for a deep-dive analysis on transaction-level data, the enhanced working capital management program it produces can provide valuable intelligence into payment trends and behaviors. That may be important in an era of economic uncertainty, where a strong approach to managing working capital can make a difference in how an organization might withstand headwinds.

—by Kirk Blair, partner, Deloitte Financial Advisory Services LLP and Wanya du Preez, manager, Deloitte Transactions and Business Analytics LLP

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