Vizant

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Thoughts on Working Capital

As a financial executive, there is nothing more important in your financial responsibilities than that of managing your organizations liquidity and working capital. After all, it is the main reason most CFO's, Controllers and Treasurers are an integral part of every organization. While there are many other important functions and responsibilities in your position, the *generation of cash, the preservation of cash and the ongoing management of cash* is what it is all about. Most importantly, it all starts with the *efficiency and the depth of the accounts receivable and accounts payable functions.*

As a company that specializes in the efficiency and maximization of financial operations and its associated resources, there is little that we have not seen when it comes to what are considered core financial functions. So, let's start with some very simple definitions of some key liquidity terms: Accounts Receivable (AR), Accounts Payable (AP) and Working Capital (WC). Accounts Receivable: Sales and or services made and revenue recorded, for which the customer has not yet paid. Basically, no more than a promise (and an unsecured one), that a customer will pay you in the future. Accounts Payable: Amounts that are owed to suppliers for goods received or services rendered, aka trade creditors. Basically, no more than your promise (and an unsecured one), that you will pay a vendor in the future. What we have here is that the key aspects of working capital are based on promise to pay. *The day to day management of accounts receivable and accounts payable is the driver behind maximizing working capital.*

Working Capital (WC) management must be the number one financial priority for every financial executive. Working capital is simply defined by the amount by which current assets exceeds current liabilities. From an individual and personal perspective, think of working capital like this: How much cash do you have in the bank plus your expected income over the next 4 weeks less your expected expenses that need to be paid in the next 4 weeks. Liquidity is all about working capital management: the greater the working capital, the better the liquidity. *The best method to managing working capital is to be very proactive when it comes to the Cash Conversion Cycle (CCC).*

The cash conversion cycle (CCC) for any organization, while a rather simple metric to evaluate a company's working capital prowess, is often overlooked by many seasoned financial executives. What is the CCC? CCC basically measures cash and the flow of funds as it moves through working capital accounts or another way of defining it is as follows: How much time it takes for revenue to be turned into cash, *from the point when funds are disbursed to initiate and support a revenue generating activity.*

For example, a company that manufactures goods has many activities that impact its cash conversion cycle, including the following: 1) purchase of raw materials; 2) holding of completed

inventory; 3) process of selling the finished goods; 4) accounts receivable and billing; 5) collections of payment; and 6) disbursement of funds to suppliers. If all purchases and payments were cash transactions, then the CCC would be a simple calculation: *days from payment to procure the goods to days cash received for payment on the sale*. That is not the case in the business world. In the end, since most companies are extended credit by their suppliers and they in turn extend credit to their customers, the CCC metric is determined as follows: time(days) between disbursement of AP and the collection of AR.

As an example, let's put it to numbers for a manufacturer: The Cash Conversion Cycle (CCC) would be calculated as follows: Days Sales in Inventory (DSI) Plus Days Sales Outstanding (DSO) Less Days Payables Outstanding (DPO). If a company has DSI of 60 Days and DSO of 46 Days and DPO of 40 Days, then its CCC is 66 Days(60 + 46 – 40). This means that the Company on average must finance its cash outflow for 60 days, until it receives a cash inflow, i.e. payment from a customer. The shorter the cash conversion cycle, the more financially efficient and the more liquidity for a Company's balance sheet. The finance team must work diligently to decrease DSI, decrease DSO and increase DPO to the maximum intent possible. A few days of improvement in each can have a dramatic overall impact.

While this may be simple math, *it is much more complicated to execute in reality.* Why? Because there are so many processes, systems, legacy procedures and unique business operational challenges that impact this metric and translate to less than excellent working capital management. Financial managers tend to focus on *the number, the metric and the acronym* without taking a deep dive into what truly drives cash and working capital maximization.

The best decision that a CFO or Treasurer can make is to take off the green eyeshade and have an Efficiency Expert evaluate and assess all of their built in processes and systems: ***As we like to say: the real costs and numbers are not always in the ledger.***