Perspective

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The Dash for Cash
Part I: Improving Accounts Receivable Management to Increase Liquidity

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EXECUTIVE SUMMARY

We are in a serious dash for cash. Whether the goal is to win market share or merely to survive the economic spiral, companies must build sustainable cash positions. This demands a fundamentally different and comprehensive approach to accounts receivable (AR) management, one that looks across the entire order-to-cash process to root out payment problems early on and design flexible solutions that release more cash and permanently lower AR.

Manage the Whole Order-to-Cash Process

Only a year ago, the marketplace viewed companies with large cash reserves as inefficient laggards, ripe for acquisition. The name of the game was leverage, and any "leftover cash" went back to shareholders in the form of dividends or stock buybacks.

Times have changed—radically. Today, cash is king. Cheap, easy credit is gone. When financing is available—and often it is not—the premiums that banks demand are prohibitive. Adding to the pain is a deepening recession that's crimping cash flows and forcing corporate belt-tightening across the board in an effort to conserve the cash that is still coming in the door.

The very survival of many corporations as going concerns is under threat. As Thomas Friedman, economics editor at the *New York Times*, recently put it, "There is a storm coming, and it hasn't even hit yet." But there is a silver lining for those companies with strong cash positions. They will have the financial muscle to move against weaker competitors and make market share gains.

The lesson is clear: We are in a serious dash for cash. Whether the goal is to take market share or merely to survive the economic spiral, companies must build sustainable cash positions. This demands a fundamentally different and comprehensive approach to accounts receivable management, one that looks across the entire order-to-cash process to root out payment problems early on and design flexible solutions that release more cash and permanently lower AR.

HIGHLIGHTS

- Companies must increase their cash positions on a sustainable basis in today's tough economic and credit environment. They can accomplish this by better mining their own balance sheets' near-cash assets.
- To better mine these assets, companies need to revamp their AR management. Specifically, they must improve their attention to the entire order-to-cash process, not just focus on overdue payments.
- By focusing on each bucket in the order-to-cash process, companies can identify problems earlier, design better solutions, accelerate payments, and increase liquidity.
- For large companies, a 5 to 10 percent reduction in AR is achievable and would release tens of millions of dollars of cash.

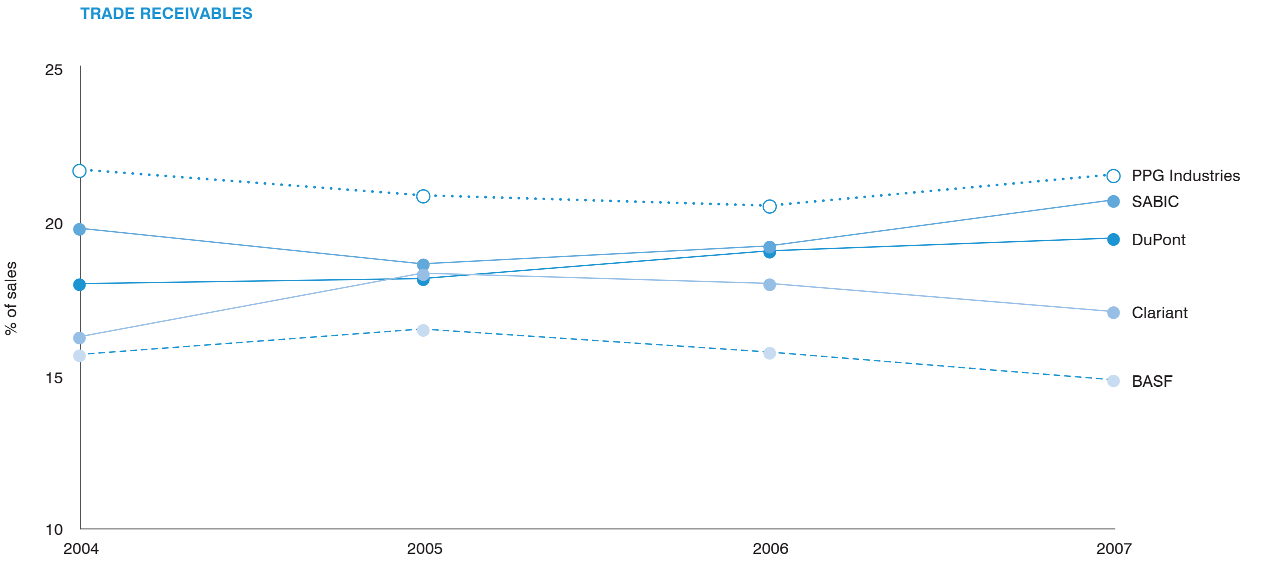
TAP HIDDEN CASH ON THE BALANCE SHEET

Fundamentally, the purpose of cash conservation is to improve the quality and viability of a corporation's cash flow statement. To achieve this goal, most corporations focus on improving the P&L; however, that alone is too narrow an approach. As we all know, making a sale is one thing, but getting the cash from the sale into the bank is quite another.

In addition to improving the P&L, companies must do a better job of tapping the hidden cash on their balance sheets. Improving balance sheet liquidity involves preserving and then enhancing a corporation's cash position in relation to its current liabilities. On the asset side of the balance sheet, any asset can theoretically be converted into cash; in reality, this is not the case, as we're witnessing today. Selling long-term assets to generate cash during periods of depressed asset prices is an act of desperation. Instead, to raise cash and boost liquidity, managers should turn to cash equivalents on the balance sheet, especially near-cash assets such as inventory and accounts receivable.

The opportunities to mine these cash equivalents vary from company to company. In the chemicals industry, for instance, trade receivables as a percentage of sales have ranged between 15 and 25 percent for the last several years *(see Exhibit 1)*. The monetary implications of these percentages are enormous, often hundreds of millions of dollars. Reducing these percentages by a mere 5 to 10 percent, a quite achievable goal in our experience, can release tens of millions of dollars of cash.

Exhibit 1
Trade Receivables as a Percentage of Sales



Source: Annual reports; Booz & Company

RETHINK THE BASICS OF MEASURING AR: WHAT AND HOW

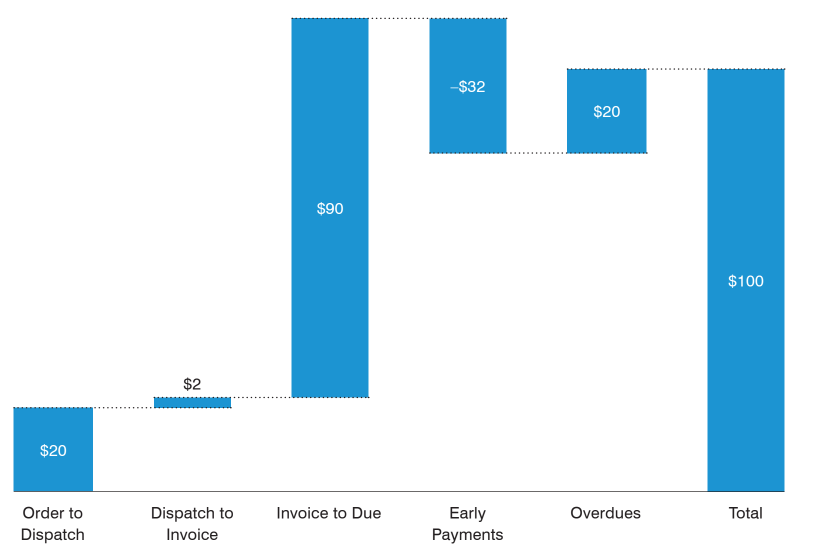
Today, many companies miss this liquidity potential by tolerating far too many inefficiencies in the order-to-cash process, thus allowing "near cash" to languish as "not cash." Instead of managing each of the order-to-cash process's five buckets, companies tend to ignore the earlier buckets, where many problems arise, and focus on the overdue problems at the end of each quarter *(see Exhibit 2)*. Old habits die hard, and many poor AR management habits are deeply ingrained, but improving management so that AR are permanently reduced is critical for success in today's environment.

The first step toward better AR management is to change what you measure. Many companies use "invoice to cash" or "dispatch to cash" to tally their AR numbers, but these are just slices of the AR process and exclude critical pieces of information. Companies should take a broader view by measuring the entire order-to-cash process. This helps to uncover the root causes of poor receivables, which sometimes trace back to before the invoice, such as incorrect customer data, erroneous order capture, or late dispatch.

By focusing on the root causes of payment problems and managing each bucket of the order-to-cash process, companies can avoid the often manic, last-ditch effort to improve AR at the end of each quarter, an inefficient use of resources that doesn't address the root of the problem and therefore will have to be repeated in three months. Ultimately, taking a holistic approach to the order-to-cash process makes AR reduction more sustainable.

The second step to improved AR management is to change how you measure. Companies typically use a point in time, such as month's end, to measure their receivables. Instead, companies should calculate an average AR. This measurement gives a company a truer understanding of its AR status. For example, if $100 million of invoices are raised on the 5th of a month to be paid on the 25th, an end-of-the month, point-in-time measurement would not capture the impact of these receivables. But an average AR measurement would. That's not to say these numbers are easy to generate. To calculate this average AR, a company must delve into individual orders and invoices over a period of time.

Exhibit 2
There Is Potential to Unlock Cash in Areas Often Overlooked in the Order-to-Cash Process



Source: Booz & Company

THE FIVE BUCKETS IN THE ORDER-TO-CASH PROCESS

Once a company changes what it measures and how it measures, the next step is to apply those measurements across the order-to-cash process, giving attention to all five buckets. Each bucket has its own characteristics and requires its own solutions to unlock liquidity, speed order to cash, and lower average AR.

Order to Dispatch: Usually working capital in this bucket is calculated as part of inventory and does not show up in the official AR numbers. However, often the causes of customer dissatisfaction and late payments are rooted here, e.g., poor back-order processes, product delivery errors, a cumbersome shipment process, etc. Attention to this area can speed up inventory turnaround and reduce late customer payments.

Dispatch to Invoice: The use of automated, dispatch-linked invoicing has improved the efficiencies in this bucket. However, analysis often uncovers problems, such as batch invoicing, missing invoices, and poor invoice quality, that trap working capital and can lead to problems later in the order-to-cash process.

Invoice to Due (a.k.a., payment term): Of the five buckets, this bucket contains by far the most working capital and offers enormous potential to accelerate payments and unlock cash. Yet this bucket often receives surprisingly little attention because the sales force and credit teams focus their efforts on the overdue AR later in the process.

The overarching philosophy is that payment terms should be simple, specific, and fit-for-purpose. Simplicity cuts and rationalizes the number of payment terms, thus reducing complexity, administrative burden, and the chance of errors. Specificity (e.g., giving customers payment terms clearly linked to the invoice day, rather than the end of the month) reduces the chances that customers can game the system by timing their orders, makes payment terms more uniform across customers, and reduces the workload of staff. Fitness for purpose differentiates among customers, offering tailored payment terms for high-value customers and more generic payment terms for less valuable ones.

Careful analysis of the current invoice-to-due situation at an invoice and customer level helps quantify the potential working capital benefit of these different payment terms. By "quantify," we mean putting a dollar value on the difference between the current invoice-to-due situation and the ideal situation envisioned by the overarching philosophy. Solutions include the reduction of non-standard payment terms, moving from "end-of-month" to "date-of-invoice" invoicing, aligning the payment terms of the customer to the sales and margin contributions, and identifying and resolving outliers.

Early Payments: These are the "good guys" of the AR world. A few customers pay early as a matter of course through fixed bank payments. However, most pay early only when incentivized, usually with discounts. A company's challenge is to maximize the early payment potential without giving away too much. To do so, a company needs to calculate the benefit of an AR reduction, which also represents the maximum discount a company can offer the customer without losing money, and then decide how much value it must cede to the customer to encourage early payment. As part of the discount offer, companies should clearly define discount-linked payment terms by offering two choices—e.g., one payment term for "short, with a discount" and one for "standard, with no discount"—instead of offering one payment term with many embedded options. Discounts are powerful tools to encourage fundamental changes in payment terms, and over time price increases can reduce the effect of the discounts.

Overdues: This final bucket is classic AR reduction territory, and it gets plenty of management's attention, especially at the end of reporting periods. However, the tactics to unlock cash are often blunt instruments—working the phones, withholding further sales, etc.—which leave the underlying causes of the late payment unaddressed. Even at this late stage, there are better ways to manage and reduce AR than those practiced at most institutions. Firms must prioritize the collection effort and then apply specific solutions, bearing in mind at all times that overdues fall into two distinct categories, intentional and unintentional, and each requires a different approach.

To create a prioritized list of customers who need special focus, companies need to examine three critical overdue traits: the magnitude (size of the overdue amounts), age (how long have the amounts been overdue), and frequency (who are the repeat offenders). Once prioritized, solutions fall into three broad categories: payment method (e.g., automation or demanding cash in advance), sales processes (e.g., reducing invoicing errors, introducing e-invoicing, or sending regular statements), and credit processes (e.g., credit checks, stop payments, or dunning procedures).

SUSTAINABLE CHANGE FOR CASH-STRAPPED TIMES

The need for cash in today's worrisome business climate is starkly apparent, and companies must act on multiple fronts to conserve cash and steel themselves for tough times ahead. One underappreciated source of cash is a company's own AR. By establishing procedures that push near-cash assets into actual cash, a company can create a more liquid balance sheet on a sustainable basis.

This effort requires a new approach to AR management. By adopting a holistic approach to the order-to-cash process and focusing on average AR instead of point-in-time AR, companies can better identify payment problems earlier and design solutions. Thus a company can accelerate payments, reduce AR, and boost its cash position. For many companies, a sustainable 10 percent improvement in cash release during the order-to-cash process is possible. We think of AR reduction like a spring-loaded starting block: an enviable advantage in management's dash for cash.

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