

**Managing working capital in the  
new economic environment**



## Challenging times

The problem is acknowledged throughout the world: in difficult economic times, the successful management of cash flow and working capital is often crucial to business success – even to business survival.

Ben Bernanke, Chairman of the Federal Reserve, says that “shortening the cash cycle and better use of working capital” is the most important factor as private sector organisations struggle to overcome current economic volatility and the increasing difficulty of accessing capital markets.

That’s also the view of the IBM Institute for Business Value. It says that the current environment is “placing unprecedented constraints on access to credit and capital”, and there is widespread agreement that “cash flow and working capital management will be central to survival, growth, and strategic flexibility”.<sup>1</sup>

Finance executives know from their own experience that it is true. In a recent independent study of more than 500 CFOs in the US, Europe, and the UK, 24% of respondents said that cash management was the most important issue facing them. A further 61% cited it as one of the three top priorities for their business over the next year.

But recognising the problem is one thing: managing it is another. Only 14% of CFOs in the survey said that they possessed the capabilities to forecast cash accurately. A consistent theme among companies trying to respond to the current economic environment, to maintain growth, or even simply to survive is the lack of visibility and measurability associated with cash and working capital.

This paper will study the knowledge gap that faces those organisations which lack effective working capital management techniques, and how it can be closed.

## New perspectives

In summer 2008, IBM conducted its own independent study of publicly available receivables, payables, and inventory data from more than 130 organisations that had either headquarters or major divisional operations in the UK. By providing a benchmark analysis of working capital management within the organisations, which covered 14 industry sectors, we were able to offer new perspectives on the release of organic sources of free cash flow.

The study had three main aims:

- To get a **fact-based understanding** of the real impact that the current financial services and credit liquidity situation was having, or was likely to have, on other sectors
- To isolate and identify the **root causes why some organisations struggle with cash flow and working capital management** – above and beyond the impact of the current economic environment
- To show how leading organisations are **finding ways to improve cash flow**, without relying on external sources.

We found that the key was to focus both performance management and incentive mechanisms on working capital and cash, to get back to basics, to gain effective insight, and to release cash organically. By observing those priorities, even organisations which were traditionally reliant on cash from external financing were performing potentially more successfully despite the wider problems of the economy.

Overall, operating cashflow for all the companies in the study was down 3.5% by the end of 2007 – but that figure was made much more serious by the economic downturn of 2008, and the resulting pressure on cash flow. By updating a sub-sample of our original group at the end of July 2008, we found an additional erosion in cash flow of 12%.

## The size of the opportunity

Our studies showed that among 15 of the top pharmaceutical companies in the US, UK, and Europe, from 3%-7% of sales could be organically released in the form of free cash flow by improving their figures for Days Sales On Hand (DSO), Days Payable On Hand (DPO), and Days Inventory On Hand (DIO or DIH) so they achieved the average performance in the sector. Further simple measures such as standardising supplier terms, enforcing contracted customer terms, and settling disputes and queries quickly, could generate up to \$35 billion of working capital each year.

Among the main aspects of company performance determining operating cash flow are:

- *DSO – the time it takes on average to convert sales to cash*
- *DPO – the time it takes on average for a company to pay its suppliers*
- *DIO or DOH – the average time that an organisation maintains inventory and incurs carrying costs.*

Among the 130 organisations benchmarked, the results varied widely:

- *Average DSO was 53.3, with a cross-sector best practice of 17.9, and worst case 128*
- *Average DPO was 79.2, with a best practice of 267.2, and worst case of 7.2*
- *Average DOH was 52.1, with a best practice of 0.6 and worst case 159.*

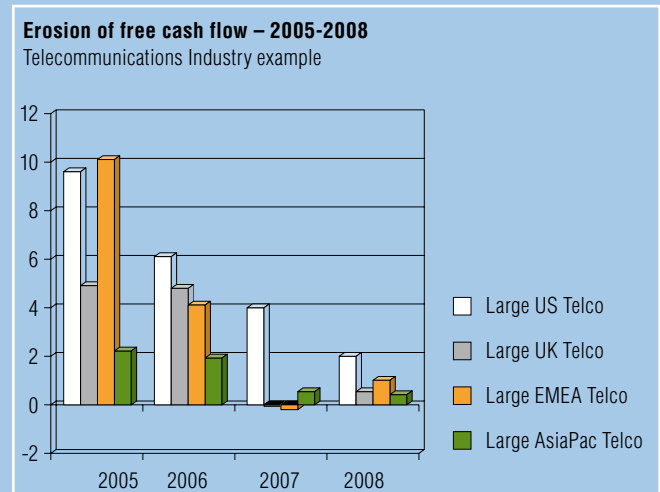
The analysis studied the correlation between performance in DSO, DPO, and DOH and the impact on free cash flow, dividing the benchmarked companies into quartiles.

- *There was a 34% gap between median performance and the first quartile, indicating a fairly significant difference between average and top performers across all three metrics.*
- *The greatest correlation with top operating cash flow performance came from DSO – i.e. the ability to manage receivables effectively and convert sales to cash. For example, companies which managed their operating cash flow most successfully had an average DSO of 15 days less than merely average performers.*
- *Many of the companies performed extremely poorly. For example, a 72% difference in DSO between average performers and companies in the fourth quartile demonstrated the seriousness of the problems that some organisations were experiencing with cash management practices.*

Every one of the 14 industry groups included in our analysis experienced increasing problems in DSO between 2006 and 2007. In the electronics and manufacturing sector, the delay in converting sales to cash increased by 37%; in utilities, it was up by 22%, in petrochemicals by 19%, and in the media, news and broadcasting sector, 12%.

This demonstrated a trend for customers to pay more slowly that started well before the more visible effects of the credit crunch. A study of more than 1,000 companies across Europe conducted by the Customer Value Group during Q1 of 2008 revealed 71% had experienced an increase over the previous 12 months in the receivables balance due to them. The average increase was 15.4%. Our study confirms that receivables management is now a top concern, affected by the dual impact of the credit crunch and the recession.

On the payables side of the ledger, organisations are consistently seeing increasing demands from suppliers for prompt payment. More than 36% of companies in our study reported a tightening of credit arrangements over the past 12 months, and 18% said they had experienced a tightening of commercial terms. As suppliers demand payment more quickly, and customers offer payment more slowly, every industry sector surveyed has seen the 'float gap' between DPO and DSO shrink during the last year. In petrochemicals, it has fallen by 78%, in the auto industry by 56%, and in utilities by 56%.



- Get the facts – isolate root causes of cash and working capital under-performance
- Pilot initiatives to release organic sources of free cash flow – don't try to boil the ocean
- Align performance metrics and incentives against operating cash flow
- Focus on DSO – improved receivables management, credit and collections will bring the quickest results
- Aggressively manage suppliers and payment terms
- Invest in tools to bring better insight and cash forecasting.

### **So what about the good news?**

But the survey did not provide only bad news. The successful performers – those in the top quartile of companies surveyed – have found effective ways to improve organic cashflow management. So how have they done it?

- *By setting up end-to-end visibility of the root causes of difficulties in the management of receivables, payables, and inventories. Measures are put in place at operational and process levels to drive top performance; data and reporting mechanisms are tightly integrated with the planning and forecasting processes; incentives are introduced throughout the organisation, and especially in sales and marketing, to encourage effectiveness in the management of cash and working capital.*
- *Management has access to data which enables comparisons of the company's performance with industry averages and with what can be achieved.*
- *Quick-win initiatives are introduced to generate momentum fast, and to fund broader, sustainable solutions. Over-ambitious schemes for working capital and cash management are generally less successful than getting back to basics and organically releasing cash from core operational sources.*
- *Streamlining order management processes to eliminate simple contract validation or pricing errors that led to disputes and slower payments*
- *Using focused outbound calling campaigns to keep customers in an active buying cycle and help organisations better prioritise their efforts to collect cash.*
- *Using advanced cash management software to speed up the handling of disputes, and automatically enforce business rules in compliance with cash management policies*
- *Conducting a simple trade-off analysis to determine the comparative effect on working capital of extended terms and discounts to customers*
- *Establishing incentives throughout the company to encourage the achievement of cash-focused objectives. One first-quartile company in the study targeted all incentives for its top 500 senior executives to encourage a focus on cash and working capital management.*

Tactical, quick-win initiatives have been deployed particularly in the area of receivables management, focused on better managing credit exposure and more quickly converting sales to cash. The following examples helped to release organic cash within 6-9 months of implementation:

A recent study of the new economic environment by IBM's Institute for Business Value highlights how important it is to have clear visibility of management processes of receivables, payables, and inventories, and also to be able to measure results effectively. The study cites:

- *The ability to consolidate and standardise data about working capital performance*
- *Using tools to make and drive fact-based decisions and perspectives in the business*
- *Creating multidimensional views of working capital performance differentiated by business segment, service, and/or product, so that needed process improvements or projects that drive improved cash management can be isolated and studied.*

## What we can potentially achieve

- For one major global pharmaceutical company, the working capital diagnostic helped to deliver a 30% reduction in production-related inventory costs and a 20% reduction in overall working capital expense
- For a major utility, it helped to release \$68 million working capital, through a supplier base reduction from 12,000 to 1,600
- For a major high-tech company, it helped to reduce disputes from 8.5% of Accounts Receivable to 1.7%, and cut overdue accounts by 91%. These achievements led to an overall reduction in delinquent DSO by 71%.

## So what to do about it?

IBM's research confirms the challenges that exist today – but also demonstrates the opportunity for many organisations to release cash and working capital organically more cheaply and faster, without relying on external sources.

We have developed a proprietary working capital diagnostic toolkit uniquely designed to help companies to do this. It requires minimal up front investment, and over a 6-8 week analysis period it leverages IBM's own set of more than 200 industrialised hypotheses to aim to improve working capital performance. This data-driven and fact-based programme is supplemented with leading practices and benchmarks that have been jointly developed between IBM and APQC, a leading source<sup>2</sup> of independent six-sigma best practices.

**The conclusion: the key difference between organisations that successfully meet the challenges of the current economic situation and those that don't is their ability to adopt the practices, processes, and technologies which increase their understanding of working capital performance. The challenges are great, the penalties for failure severe – but the opportunities for success are there to be seized.**

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<sup>1</sup> IBM Institute of Business Value paper, The new economic environment – A CFO perspective. Published 2008.  
GBE03142-USEN-00

<sup>2</sup> <http://www.apqc.org/portal/apqc/site?path=/aboutus/newsandevents/pressreleases/APQC-MAKE-AWARD.html>