

spotlight WORKING CAPITAL

THE NEW SON OF STAR WARS



AN EFFECTIVE WORKING CAPITAL MANAGEMENT PROCEDURE IS AN ESSENTIAL WEAPON IN TODAY'S OFTEN BRUTAL BUSINESS ENVIRONMENT, SAYS **PAT LEVY** OF FTI.

The Son of Star Wars is a plan by the US administration to develop and deploy a multi-national defensive screen that has the ability to track and destroy incoming ballistic missiles. It is a communications system that detects threats by radar, sends a signal to a satellite, launches a defence action and destroys the incoming missile. Recent events have put this missile defence programme on top of the US defence agenda.

Equally, companies are also exposed to the threat of ballistic missiles, some, in the guise of the technology bubble burst, the US recession, global economic slowdown and 11 September, have inflicted serious, if not fatal, damage. This raises two important questions for businesses:

- are the conventional weapons in a treasurer's arsenal adequate to protect against unexpected business and environmental shocks? and
- is it necessary to develop and deploy a new multi-organisational defence system?

In recent years, companies have successfully adopted an offensive strategy focused on growth, but at the same time they have neglected the defensive province of costs and cash. For many companies a defence structure was not in place to respond to early warning signals of business and economic threats and it is only now that they are trying to secure their bottom line through attention on costs and focus on working capital.

We are all familiar with the adage 'the first line of attack is defence', and it is important to address core issues, even in a growth environment. There is a lesson here for treasurers and CFOs, and it is time to take stock of the machinery of working capital management.

MISSION. UN security council resolutions specify precisely the role and mission for all engagements to ensure that the plot is not lost. The plot was most certainly lost by companies which, in recent times, have found themselves either in an over-trading position or with cash shortages as a consequence of the economic downturn. The working capital mission is simply presented in *Table 1* and shows

TABLE 1
THE HIGH PRICE OF MISMANAGING WORKING CAPITAL.

Sales price = £5, received next day
Cost = £4, payable same day
Credit = £100

Day	No. of sales	Cash in	Cash out	Cash balance
1	1	0	-4	-4
2	2	5	-8	-7
3	4	10	-16	-13
4	8	20	-32	-25
5	16	40	-64	-49
6	32	80	-128	-97
7	64	160	-256	-193

how a profitable business can quickly get into difficulties if working capital is not effectively managed – terminally ill and in the red in just seven days!

This illustration more interestingly identifies the three components of working capital management: cash management (cash balance); supply chain management (cash out); and demand based management (cash in).

These are the three conventional weapons currently used in working capital management and all significantly affect the ultimate goal – that is, liquidity. *Table 1* goes further and shows the effect on liquidity when each of these three allied forces are not working in unison.

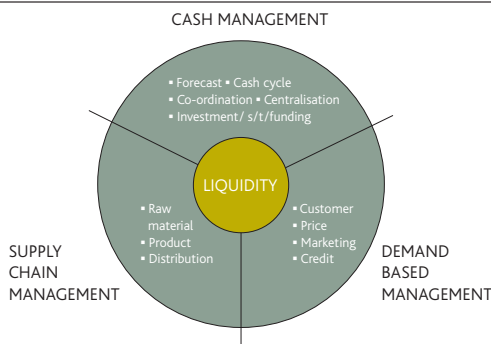
CONVENTIONAL WEAPONS. While treasury has responsibility for ultimate liquidity, it often only focuses on one side of the working capital paradigm: cash management. This focus is on access to cash and information, maximising efficiencies and minimising costs, rationalising banking services and securing control over the company's asset. The conventional view of cash management falls into the following categories:

- cash flow forecasting;
- the cash cycle – money transmission, payment systems, clearing and value dating;
- cash co-ordination – inter-company netting, sweeping and pooling;
- cash centralisation – global and regional cash management structures; and
- cash investment and short-term borrowing.

A systems and control infrastructure that includes electronic funds transfer and balance reporting, multi-banking capability and treasury management systems has been built to make the process effective. The communications capability of this infrastructure has been enhanced by the internet, as seen by the web enablement of electronic banking systems. The cash management component of working capital management is in the front line of the combat zone, and treasury personnel operate as a marine corps, handling and managing the explosive raw material of cash.

Recent military engagements teach us that war is not won on the battlefield but in the planning and logistics of the engagement. For this reason, the logistical effort of materials and parts, work-in-progress and finished goods, supply and distribution (collectively known as supply-chain management) is essential to the working

FIGURE 1
MANAGING LIQUIDITY



capital solution. Supply chain management is a second weapon that significantly affects working capital. It has become more important in recent years as the concept of just-in-time (JIT) manufacturing is placing the responsibility for stock on the supplier, forcing companies to effectively and accurately plan for the supply of its products. Supply chain management is supported by dedicated software applications that are now being challenged by enterprise resource planning (ERP) packages which provide a more integrated and broader offering.

The traditional view of demand based management (DBM) focuses on debtors and credit management. DBM now seeks to co-ordinate customer requirements with planning and scheduling, essentially linking and relating the selling side of the cycle to the supply chain.

The concentration is on the customer, pricing and marketing strategy and seeks to relate customers' forecast requirements to supply levels. The complexity of different markets, products, prices, distribution channels and the like lends itself to systems based support. DBM is a third weapon in the working capital management arsenal.

COMMUNICATIONS CAPABILITY. The three weapons of working capital management (cash management, supply chain management and demand based management) often operate in isolation, with little communication between each other. There has been some movement in linking supply and demand elements to create a 'value' chain process. An example of this is on-line ordering linked directly to the manufacturing system by way of electronic data interchange. However, the technology solution is far from complete.

Clearly, the internet offers a platform for real-time remote access communication. The development of ERP packages promise to offer the Holy Grail but the expense and lengthy implementation are key negatives, and the solution is not suitable for many small and medium-sized companies. The real technology challenge is the simplification of applications integration based on common benchmarks and standards and much has yet to be done in this area.

A solution that overcomes the difficulty of expense and time is the outsourcing offerings by both supply chain and treasury management agencies. These services offer access to expert resources which use established infrastructures and tested methodologies that result in less expensive and more flexible organisational arrangements – important for management who wish to spend more time on strategic, rather than routine, issues.

MULTI-ORGANISATIONAL DEFENCE SYSTEM. Value chain systems and ERP packages are not enterprise wide solutions if the front line of cash management is not included in the defence line-up. Similarly, cash management is only part of the working capital management process. Total enterprise wide working capital management integrates the three elements of cash, supply and demand. Sun Tzu, the Chinese warrior philosopher of the eighth century BC, in his treatise on war and military science, advocates that: "It is imperative to contest all factions for complete victory." Integrated enterprise wide working capital management offers an opportunity for a multi-organisational defence system aimed at optimising and protecting the liquidity position of a company.

IN COMMAND. Since cash management is the front line of working capital management, the treasurer is in a leading command position. There is a need in many firms for a central authority to drive the way forward in integrating issues such as this on a company wide basis. Treasurers are well placed to fill this role and treasuries should review their traditional perspective of working capital management, with a view to adopting an enterprise wide mission.

WINNING THE BATTLE. While the merits of a US defense system are unclear, the benefits of an integrated working capital model has real intrinsic value. It provides a communications platform that can detect threats to liquidity and their sources and sends a signal to management, who can respond quickly by launching a defensive action to protect the company from incoming missiles. While new technology can support this strategy, the initial step is to consider working capital from an integrated perspective and for an authority, such as the treasurer, to take responsibility for optimising the process. An integrated approach offers a strategic defence structure that is automatically deployed to protect against external economic and environmental shocks and attacks.

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