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Symptoms of Poor Cash Management

Key Takeaways

- **Tight receivables management is a priority for cash conservation.** Operational levers can be used to extract excess cash tied up in working capital, providing a more attractive source of cash than other forms of liquidity.
- **Tight receivables management also minimizes exposure to doubtful collections.** Customer financial exposure has cash flow implications for customers with long payment terms, or poor payment histories against contracted terms.
- **Uncovering the source of poor cash management requires data driven diagnostics to audit the order-to-cash process.** Recent volume swings can distort cash management metrics as well as reinforce weak internal collections measurement practices.
- **Customers are also managing cash through payables.** While many companies are looking to extract excess cash from receivables, many customers are also using payables as a source to reduce working capital levels.

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Customer payment profiles

"All happy families are alike; each unhappy family is unhappy in its own way." — From Tolstoy's *Anna Karenina*

The same can be said for customer payables. All good customers pay on time in the same way, but each customer with poor payment habits is unique. The following shows the four common profiles of poor customer payment histories: **S**luggish, **S**traggler, **S**loppy and **S**chizophrenic. Uncovering the offending customer behavior is the first step to improving cash management.

To create a customer payment profile, Cost and Capital's approach is to examine payment history over a length of time to compare the submission date to the date that payment is received. Delays often occur for reasons including physical receipt of payment, data transfer, weak customer systems, approvals, disputes, as well as blatant efforts to slow payment. Cash performance is derived from the following:

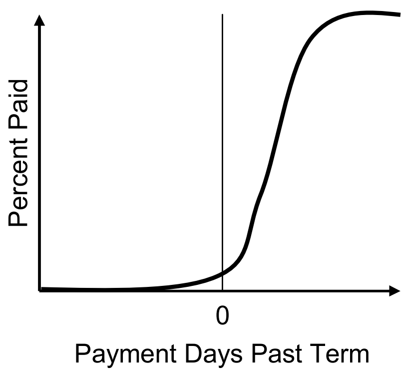
1. **Percent paid on-time** – This is the percentage of invoice dollars that are received by the due date in the system.

2. **Days to reach 95% paid –** This is how many days past term it takes for 95% of invoiced to be paid.

3. **Average days overdue** – The weighted average days late of open and late receivables.

Sluggish customers are characterized by payments consistently a few days late

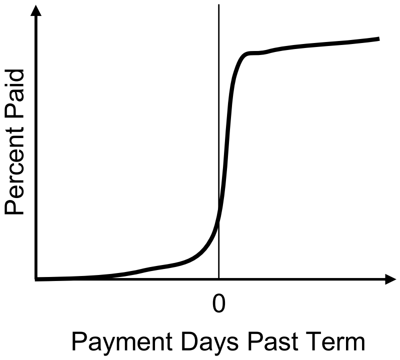
Payment history analysis that shows consistently late performance against term is a sign that customers have a disciplined payables process, where either they have a different understanding of the payment terms or specifically choose to add days to terms or start aging invoices late. For many companies, adding "processing days" to invoices is a common way to extend payables without negotiating with suppliers.



The best way to combat these cash management inaccuracies is with data. Fact-based customer agendas and scorecards serve to both make customers aware of contract non-conformance and also lets customers know that the supplier is actively measuring and managing receivables. The root cause of sluggish performance can be definitions for when invoices start aging, internal or customer process delays, willful interference of invoice payment and lack of attention.

Engaging sluggish customers requires a willingness to confront the customers with the offending data. Updating contracts with clearer payment term language or penalizing customers with higher future sales prices can increase customer payment compliance.

Straggler customers are characterized by payment of most invoices on-time, but are slow to reach 95% of invoices paid

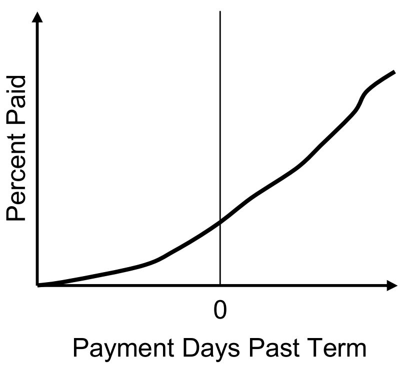


Some customers manage cash by creating a rigid approval process and diverting a large amount of invoices into an exception process. Disputes can arise due to pricing, delivery, quality and process. While some disputes are justified, some companies use the dispute process as a key element of their cash management activities. In one example, the automaker Chrysler has recently taken an average of 287 days to resolve disputed invoices.[1] Customers employing this tactic may place a supplier's financial health at risk and strain business relationships. At Chrysler, new leadership attacked this practice and has driven disputed invoice resolution times down to 105 days. Tracking the number of disputes and historical time to reach 95% payment are two ways to measure the customer behavior and address any potential abuses of the system.

Engaging straggler customers requires active account management including invoice monitoring and rapid response at the first instance of disputes.

Customers that wish to resolve disputes should be required to document non-payment reasons, provide leadership escalation steps and penalties for frivolous disputes. Dispute management also requires active internal problem resolution to ensure compliance with the contracted terms.

Sloppy customers are characterized by a haphazard payment history



Customers without a defined profile payment date indicate poor internal controls and processes. The payables function at these customers is often manual, understaffed and a low priority for the organization. As any manual process, engagement on the tactical level is required to create the prioritization for invoices.

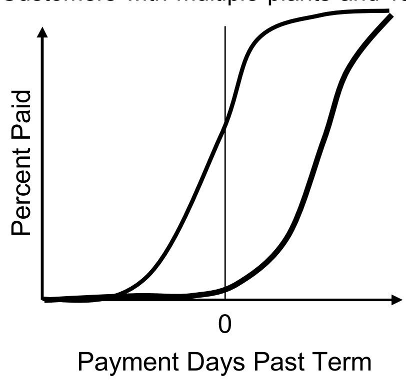
Successful tactics include motivating performance through late payment penalties, fees for non-EDI bill processing and invoice bundling to minimize the number of invoices to process.

Sloppy payment histories are also an indication of deeper customer problems. Lack of management attention in this area exposes these customers to manipulation by other business partners. As a side effect, this customer profile may be more likely to pay late fees since internal controls to restrict payment of these fees are not in place. Thus poor receivables performance is at least compensated in this category.

[1] Automotive News – January 18th 2010 *"Chrysler speeds supplier payday"*

Schizophrenic customers have multiple contract terms and inconsistent payments

Customers with multiple plants and varying contract terms create complexity in payables management. For many customers, this creates confusion in managing payables. Without a disciplined data process to manage multiple contract terms, invoices are often paid out of term.



Successful payment remedies include contract simplification, internal contract administration and structured customer communication.

Payment Schizophrenia can work either in favor of the supplier or the customer. The root cause of the disparity of payments is still the same, but the net effect is different. For example, a customer with both Net 30 and Net 45 contracts can pay near 45 days or 30 days. Payments closer to 45 days provide a net benefit to the customer, whereas with payments at 30 days the supplier benefits. Knowing the net effect of this behavior is an important part of supplier negotiations.

Customer payment diagnostics highlight key areas for improvement

Effective customer diagnosis requires data management, understanding how operational factors impact receivables and most importantly, the desire to both uncover the root causes of poor cash management and fix the underlying problem. The common payment profiles expose both the tactics and strategies to use with customers to address the non-compliant payment history. Tracking poor cash management faces the same challenges as when someone lies to his doctor. The only way to fix the problem is to be honest about the situation, perform a detailed diagnosis and apply the correct treatment for the symptoms.

Cash management reporting

Internal cash management metrics are notoriously inconsistent with measuring true balance sheet performance for receivables. Account collection functions within organizations often measure activity not results. Factors such as invoices processed and disputes resolved are tracked, but metrics that drive down receivable balances, such as days outstanding and weighted average days late are often incorrectly measured.

Collections metrics need to align with the working capital requirements of the business

"What gets measured gets done." This is a truism of organizational metrics. Aligning the metrics with company financials changes behavior and is a key objective when addressing performance improvement within the collections organization.

The goal of measuring internal collections is to reduce the amount of working capital required to run the business. Metrics that do not align with this goal encourage behaviors that do not improve working capital. Common measurement practices include measuring days starting from when the invoice process passes an internal milestone, such as entry into the system as opposed to when revenue is recognized. Other common issues are only measuring closed invoices, filtering out too much data as an exception process and measuring days late rather than days open.

Best practice cash management accountability is predicated on three key principles:

1. **Alignment to the balance sheet** – Metrics need to align with the accounting system and the consolidated balance sheet. Segmenting business units, regional and international sales, and exceptions all reduce accountability within the organization and create pockets of receivables and customers without an internal owner responsible for managing compliance.

2. **Visibility into customer behavior** – Cash metrics should be able to identify poor customer payment histories and diagnose the root causes. As all customers have unique reasons for poor performance, metrics need to be able to highlight which indicators are causing receivables to build at an individual customer.

3. **Leadership** – Too often, collections is seen as a response for only delinquent customers. The order-to-cash management position must interface with sales, operations and collections to solve open issues and resolve both internal and customer driven payment delays. The sales role is not often well positioned to confront customers with contract non-compliance. The cross-functional role eliminates internal finger pointing and creates a single point both internally and for customers to engage with billing resolution.

Cash management process

Best practice receivables management requires information, talent and tools. Information prioritizes the sparse collections resources, talent engages customers and the toolbox escalates poor customer performance.

Collections efforts must be prioritized to leverage limited resources

Most organizations default into a process where activity is monitored when a problem occurs. Most accounts receivable organizations fit this profile. The function gains visibility only when a customer declares bankruptcy or has major billing issues. Active monitoring of receivables is required to both prioritize the efforts of the collections team, but to also provide feedback to the sales function.

At the start of each day and week, the AR team should be able to quickly point out the top customer issues that are building receivables. Integrating a simple reporting algorithm into the billing system is a straightforward task, but requires allocating IT resources and a plan of what is required to focus the team on the major issues.

Efficient collection requires personnel with unique skill sets

Ideally, collections talent should include both attitudinal characteristics such as tenacity as well as analytical abilities to identify issues and engage customers with fact-based assessments.

Profiling customers and identifying the common payment profiles should be the primary analytical function of the AR team. Diagnosing poor payment and then actively improving the open issues is where the team should have the best skills and resources.

Engaging customers with facts and an understanding of the billing system requires persistence to enforce contracts and the ability to highlight issues with customers in a fair but firm approach. While these individuals are at the front lines of enforcing the company's claims, they are also customer facing and need to be able to handle customer interaction with poise.

Customers need specific tools to engage and remedy non-compliance

Some customers manage cash by creating a rigid approval process in a deliberate attempt to extend the payables process. Separating these customers from other non-payment root causes requires a toolbox that allows the team to view the data, make conclusions and then perform actions to close the gaps. A comprehensive toolbox should include:

1. **Aging file diagnostics** – Segmenting the aging file to extract data is paramount. All organizations can pull an aging file and see which accounts are the most delinquent. Combining this with the customer history as well as separating time-based measurements such as days to reach 95% paid, average days late and other characteristics create a full picture and provides a roadmap to improved cash performance.

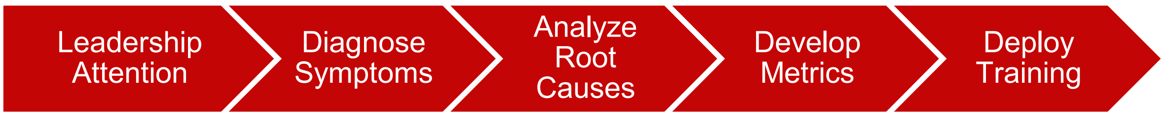
2. **Customer risk profiles** – When a customer that has consistently been on-time starts to show signs of slower payment, it can be the result of several causes—internal delivery issues, active payables management or customer financial stress. Customers that push for longer terms, or do not perform against current terms pose a risk that the invoice will not be paid. Early notification and alignment with customer financial diagnostics highlights the proper approach.

3. **Customer performance scorecards** – When a collections representative needs to engage a customer, a comprehensive scorecard with payment history, order growth and metrics empowers the representative to use data to engage the customer. Developing and implementing scorecards changes the dynamics of the customer engagement and results in identifying poor performance and tracking progress against agreed to terms.

4. **Customer engagement tools** – Some customers will pose greater challenges than others. The collections team should be authorized to assign late payment penalties and those penalties should be a standard term in all contracts. The sales team should work with the collections team to apply customer direct approaches to resolve term non-compliance and employ customer remediation plans to correct payment behavior.

Cash management improvement

World class cash management organizations require up to a third less working capital to manage receivables. Improving cash management follows a five step process:



Leadership attention – Unlocking the cash tied up in receivables requires top-level attention to the initiative. Lifting the accounts receivables function to higher level of importance within the organization serves to both motivate the team as well as uncover any weaknesses in the team, process and reporting.

Diagnose symptoms – Most teams either assume they are performing well, or have metrics that reinforce that the performance is acceptable. Diagnosing poor cash management requires a critical look at how working capital is used in the AR function as well as deconstructing the current measurements to audit the level of congruence with the financial reporting of receivables on the balance sheet.

Analyze root causes – The causes of poor cash management include customers, process and available tools. Segmenting customers and assigning a fact-based cash performance rating will uncover any games being played with the sales team to hide the true cost of poor cash customers and uncover areas where customers are working to manipulate the order-to-cash process.

Develop metrics – To improve cash performance, metrics need to be linked to the factors that drive working capital performance. Activity or invoice based metrics only serve to focus on processing to manage numbers instead of reducing the amount of working capital employed. Aligned metrics will drive collection actions that minimize the total amount of receivables.

Deploy training – A comprehensive cash management toolbox should include customer engagement tools such as scorecards, penalties and root cause analysis. Training the collections team to readily apply these tools is required to drive performance. Metrics without training will have the opposite effect on the team. The team must know how to handle customers, see how their actions impact their metrics and feel empowered to apply the tools.

Conclusion and recommendation

"Because the purpose of business is to create a customer, the business enterprise has two—and only two—basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs." – From Peter Drucker

No company will ever dominate its market by putting its talent and resources in cash management. As such, the accounts receivables function is often neglected and degenerates into a state of pain management for those involved—reacting to stimulus when billing issues warrant the attention higher up in the organization.

Efficient cash management is a compliment to the overall business. Cash released from accounts receivables reduces the invested capital levels of the business and reduces the need to secure liquidity from more expensive sources. Delivering results is a straightforward process. Cost and Capital Partners works with our clients to implement a structured AR management program complete with well-defined metrics, a complement of cash management tools and training to build team's skill set. Quantifying success and the value of a program is as simple as summarizing the total opportunity and amount of cash to release and valuing that release against the marginal borrowing costs for the company. In times of tight liquidity, AR management is important to both release cash and to make sure that AR does not grow as customers implement their own payables initiatives to extend payment terms and their own purchase-to-pay cycles.

Elevating the receivables function through working capital initiatives will shine a light on the receivables function and will drive out misused cash. Efficient receivables management can quickly release cash to the organization. The benefit from improving cash management aligns with most organizations' goal of increasing liquidity and provides a proper context for the initiative.

Strong cash management can have a material effect on earnings

Achieving best-in-class receivables management translates into real cash release as well as improves return on capital employed. With clear and direct financial results, the benefits from enacting working capital initiatives are straightforward to quantify and budget for improvement. Disciplined cash management is a hallmark of well-run companies. Cash management deficiencies should be included on fiscal plans, gap closure initiatives and liquidity modeling.