



Cash is king, so work your working capital

With credit so hard to get during this recession, the old adage that “cash is king” is even more relevant. But most companies have access to more cash than they realise, say two INSEAD professors, and it’s right in front of them, in their company balance sheets.

Kevin Kaiser and S. David Young surveyed many companies for their recent Harvard Business Review article and found that the traditional business focus on the bottom line actually ties up working capital, setting managers on a death march towards bankruptcy. They have come up with a six-part strategy to squeeze more funds from business balance sheets.

1. Don’t manage to the bottom line

“If you focus solely on the bottom line you mismanage your working capital, and you could have way too much money tied up in inventories or receivables,” says Kaiser, Affiliate Professor of Finance at INSEAD. “A supplier may lower his price to convince you to buy larger quantities than you need, but that means you have cash tied up in inventories. And the cost of financing those inventories will certainly erode your profit margins.”

“It’s a trade-off,” adds Young, INSEAD Professor of Accounting and Control. “You have to compare the benefits of acquiring large quantities of goods at a lower cost with the cost of having to carry and finance inventories. You can also try to shorten the time you’re carrying receivables,” he says. “You can call your customers close to their payment-due

date and remind them.”

Isn’t this perilously close to harassment? “Well, of course you have to use finesse,” he told INSEAD Knowledge. “It’s an opportunity to stay close to your customers, to find out how they’re doing, maybe discuss pricing, and actually help them to meet their goals.”

2. Don’t reward staff for growth alone

Young and Kaiser urge companies to veer away from the singular profit-as-incentive strategy to galvanise employees to meet goals, and instead get them to change their focus and look at the whole balance sheet, which is a pretty tough change for the traditional sales force, whose compensation plans are linked to unit- or dollar-sales generated, not on cost controls and saving working capital.

“There’s more to selling than making the deal,” Kaiser and Young contend, proposing that sales forces reconsider extended payment terms that sometimes function as rebates in disguise, and to assist generally in managing customer payments, including, in some cases, pay-on-delivery terms. This, they admit, may drive away some customers, but the compensation in shortened payments can more than make up the loss.

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3. Make sure customers will pay for quality

Putting too much time and resources into quality is another drawdown on working capital. “We’re in favour of quality,” says Young, “but we should never forget that the customer has to pay for it. It could be that the customer doesn’t want it and doesn’t want to pay for it. In that case, you’re burdening yourself with extra cost, extending your cycle time in the factory, and taking on huge amounts of work-in-process inventory and the customer just doesn’t see it.”

“There is a tendency for people who love what they’re doing to lose a little focus,” adds Kaiser. “We looked at an Italian food company that had a product they advertised as having been aged for a year. This was a quality factor for them. But they did some research and found the customer couldn’t really tell the difference and didn’t want to pay for it.”

4. De-couple receivables from payables

Then there’s the relationship between receivables and payables: what you order and pay for from your suppliers, and what you can then charge your customers. To manage through the economic crisis successfully, one should not be tied to the other. Your supplier may be providing you with something you need to get your product out, whereas your customers may be able to buy your goods and services elsewhere. It’s all about leverage and buying power.

The US car industry is a good example. “It’s in the nature of suppliers to go bankrupt before the car companies,” says Kaiser. “Suppliers couldn’t wait, while the car companies pushed their pricing pressure (from industry competition and lower sales) on to their suppliers.”

“Meanwhile, GM goes bankrupt because its customers don’t want to pay for the extras in their (GM’s) product.”

5. Beware of benchmarking

Everyone needs a yardstick, but during the recent fast-paced bubble years, too many companies used a simple set of metrics to calculate their performance. This, say Kaiser and Young, was not enough then and certainly isn’t enough today. Benchmarking can in fact be dangerous because it can convince a company it’s doing fine when another firm out there is doing better and walking away with the prize.

“These benchmarking metrics are indicators of performance, mid-average paragons, and they can put companies in a straight jacket,” claims Young.

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“Focusing on benchmarking can make you miss opportunities that come from an intimate knowledge of your value chain. GM and the US car industry got trapped in benchmarking. Toyota didn’t. Early on, they didn’t have the luxury of anyone to compare themselves to, so they created a programme of ‘continuous improvement’ in which they self-benchmarked, getting better every year based on their own metrics, and eventually blew away the competition.”

6. Beware current and quick ratios

This is what bankers use to determine your creditworthiness: a shorthand worst-case scenario predicting the future of companies looking for financing, to show what lenders can reclaim if the company defaults.

“Bankers like to see a high ratio of assets to liabilities, and that means high inventories and receivables and a low level of debt, so they know what they can sell off after you’ve gone under,” says Kaiser.

“We call this the ‘death scenario,’” says Young. “You have a payment coming due in 30 days and you pay it off in 10; you give customers more time to pay and buy huge inventories cheaper. If you actually manage to these ratios, you increase the likelihood that you will fail.”

Kaiser and Young admit that adhering to these six suggestions will require a significant shift in corporate thinking and even in compensation. But they say that, in today’s economy, corporate survival depends on creative thinking and teamwork.

“Line-of-sight indicators as the basis for compensation no longer work,” says Young. “Profit-sharing is a better method.”

“Targets are necessary,” says Kaiser, “but they shouldn’t be used as the only basis for reward, because they create negative behaviour” that can be detrimental to overall management. “Companies have to adjust, to learn. If they can’t learn, they’re going to die.”

For more, go to Kevin Kaiser and S. David Young’s article ‘Need Cash? Look Inside Your Company’ in the May edition of the [Harvard Business Review](#).

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