KPMG

CASH MANAGEMENT

The importance of preserving cash in a downturn

Insights from 2008 research into cash and working capital management

ADVISORY

AUDIT ▪ TAX ▪ ADVISORY

About the research

In 2008 KPMG in the UK commissioned CFO Research Services, part of the Economist Group of companies, to conduct research into 'The importance of preserving cash in a downturn'. The research is based on feedback from 556 finance executives from large European and US organizations, covering all major industries. The annual revenue of the organizations ranged from £350m to over £20b. CFO Europe Research Services conducted the survey and provided the statistics relating to the survey, however, all content, views and opinions outlined in this report are the responsibility of KPMG in the UK.

About the authors

Andrew Ashby
Associate Partner
KPMG in the UK

Andrew has more than eleven years of professional services experience in the areas of sales, marketing, SG&A cost reduction and cash and working capital management. He graduated in Economics and Corporate Finance from Brunel University and started his career as an equity analyst with Kleinwort Benson. Andrew joined KPMG to lead the corporate cash and working capital practice.

He specialises in helping companies improve cash flow from operations. Prior to KPMG he was the US and then European President of a specialist consulting firm focusing on cash and working capital management.

Andrew works with companies to help them identify opportunities for improving their visibility and control of cash flow around the business and supporting them with programmes to release cash locked up in working capital, tax, capex and other assets.

Andrew has been involved in over 40 working capital programmes either as the project leader or advisor releasing billions of pounds of cash for clients. Many projects have been global requiring effective programme management and co-ordination of multiple teams in different regions. The majority of projects have been focused on the implementation of sustainable improvements in working capital, achieved by driving behavioural change across businesses.

Roger Bayly
Partner
KPMG in the UK

Roger joined KPMG in 1998. He specialises in operational restructuring and turnaround of businesses in the consumer and industrial markets sector. Roger works with management teams to create and execute operational restructuring programmes.

His clients have spanned the range from multi-billion dollar global businesses to £50 million single site operations. Roger has lead projects aimed at all areas of the Profit and Loss and cash flow including new product development; supply chain reorganisation; site consolidations and outsourcing; rationalisation of back office functions, property moves and operational improvement initiatives.

Recently, Roger has led a major operational restructuring for a FTSE 100 scale industrials business aimed at taking out 15% of the cost base and improving cash performance. Roger started his career as an engineering apprentice with Jaguar Cars.

He graduated in Engineering at Cambridge University and worked on a range of Jaguar and Ford programmes before joining a start-up Engineering business. By developing and exploiting new intellectual property as well as delivering complex engineering consulting, the business established a profitable niche within the global automotive industry.

Our contributors

Ludwig Gold
Head of Corporate Finance and Controlling
Salzburg Aluminium AG

Ian Marsden
European Controller
Timkens

Blair Sellers
Chief Financial Officer
Idaho Asphalt Supply

Maciek Strozyk
Group Controller
Eurocash

Michael Buhl
Chief Financial Officer
Tele Columbus Group

Contents

The importance of preserving cash in a downturn

Executive Summary

A common characteristic of high performing companies is their constant focus on cash and working capital management.

In the current environment it is not just the high performers who are increasing their focus on cash. We are living in a time where business complexity continues to grow, globalization places increasing strains on the supply chain, and the availability of credit is no longer guaranteed. When cash from external sources is in such short supply it is the businesses that can find and release cash from their working capital and other areas across the business that will be best positioned to respond to market changes and preserve and create value for their shareholders.

Shareholders, boards and executive management committees are pressing for more focus on working capital performance to raise cash, and finance departments are reacting. According to this survey of more than 500 CFOs in the US, UK and Europe, cash management is the number one priority for almost a quarter of respondents (24 percent), while a further 61 percent describe it as one of the top priorities for the business as a whole.

In each case, CFOs are under pressure to demonstrate that they are paying full attention to working capital arrangements, so that companies can boost credit ratings, and make cash available for acquisitions. This research explores how CFOs can balance the requirements to improve the short-term needs to raise cash, with the long-term requirements to make the full spectrum of changes necessary to sustain working capital performance.

Putting the economic stresses aside, there are several compelling reasons for focusing on working capital performance over the long term.

One is that businesses have never been more complex, with the number of products, services, channels and markets multiplying all the time. Finance departments have to be constantly watchful that this complexity doesn't equate to new pockets of inefficiency and poor processes. This is certainly something many companies in the survey are worried about. More than 40 percent of respondents said business complexity was a primary trigger for action on working capital over the next three years.

The second reason for focusing on working capital is the drive for many companies to expand into a wide range of emerging markets, notably the BRIC countries of Brazil, Russia, India and China. CFOs need to free up cash for investments to take advantage of the historic growth opportunities these countries often present. However they also need to focus on how cash flow generated from new investments are repatriated, made available for further investments or returned to stakeholders.

In general, the efficiencies and opportunities to be gained from working abroad – from sourcing more goods from low-cost territories – should be weighed against the working capital risks, including that some products may be purchased on longer lead-times than previously and on shorter credit terms.

One more reason: the pressure from stakeholders – banks, analysts, investors – to focus more attentively on cash and working capital. During economic uncertainty greater weight is given to a company's ability to generate positive cash flows, after all you can't pay the bills with profit. Discounted cash flow becomes key to valuation of shareholder value, therefore attracting the attention of analysts and investors; debt holders want to feel assured the company is generating sufficient cash to meet its covenant obligations. It is no surprise then to see 50 percent of survey respondents acknowledging a significant increase in stakeholder pressure to improve cash generation and only 12 percent of companies seeing no change in stakeholder behaviour.

The survey, combined with a range of interviews with a number of leading organizations, clearly indicates how the best-performing businesses manage cash and working capital. They start with a strong focus on forward visibility and control of cash flows based on a detailed understanding of the different cash cycles in their business. They have clearly defined targets which cascade across functions into individual and business goals and incentives. Roles and responsibilities are clear to all, especially around the ownership of working capital. More important than anything, they have made cash and working capital management part of business as usual, not a one off exercise. One of the key messages from the research is that executive sponsorship and effective communication is vital to driving the message on working capital across the many parts of a typical business.

Following are the key findings from the study:

Businesses are beginning to really feel the effects of the credit crunch.

The survey finds that economic pressures are having a significant impact on funding and customer and supplier behavior. The rising cost of debt is restricting investments, leading companies to reassess their financing arrangements. The majority of respondents said the credit crunch was substantially reducing their access to credit, or significantly raising the cost of that credit. Large numbers also said their customers were delaying paying bills, or that their suppliers were asking for prompter payment of invoices.

Companies are focusing on short-term fixes.

Understandably, companies are doing what they can to relieve the pressure caused by the credit crunch, negotiating longer payment terms with their suppliers, and tightening their customers' lines to credit. Close to half of the respondents said they were lengthening payment schedules and tightening credit terms. Of concern is that, in focusing on short-term fixes, companies fail to drive through sustained improvements to working capital performance, particularly in the areas of more accurate forecasting, designing better incentive packages, and improving communication to different parts of the enterprise. In addition given the far reaching impact of the economic downturn, these short-term fixes increase the risk of driving suppliers into financial distress, potentially resulting in significant costs to the business if manufacturing is halted and customer orders delayed.

Cash flow forecasting isn't accurate enough.

To reach their goals and improve working capital performance, cash flow forecasting needs to become more accurate. Only 14 percent of respondents said their forecasts were on target during the past 12 months. More than a quarter said their forecasts were out by greater than 30 percent. Improving cash flow forecasting requires managers to establish clear reporting formats, and clear bright lines of responsibility for all budget holders to communicate the required information with concise documented assumptions from business units to the finance organization. It also means challenging and reviewing submissions, and maintaining focus over the long-term.

Incentive packages are correlated with working capital performance.

The research demonstrated that the best-performing organizations link working capital performance to managerial incentives. Those that link incentives to cash and working capital did better over the last three years and expect to suffer less over the next three years. The survey also shows that almost a quarter of organizations have established no relationship between working capital and pay.

Successful working capital programs require consistent executive sponsorship and alignment of goals and incentives across functions

More than 80 percent of respondents said that consistent executive sponsorship was "important" or "very important" to the success of a working capital program. Of highest importance was achieving clear alignment of goals across functions with the business and driving these down to the individual level.

Section 1:
Surviving the crunch

The effects of the credit crunch on working capital have been wide-ranging and severe, leaving CFOs scrambling to respond.

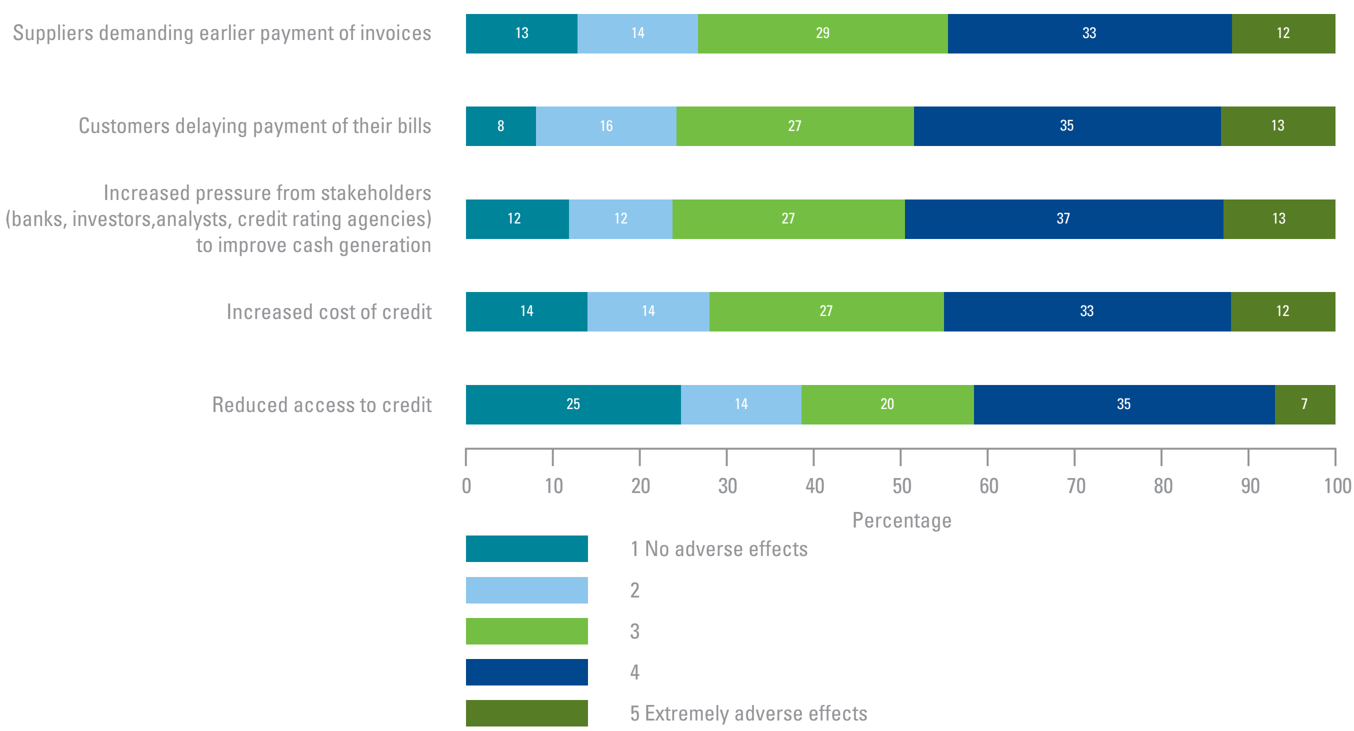
Understandably in an emergency, short-term fixes have carried the day, but are they sustainable?

There is a similar story at hundreds of businesses across Europe and beyond. The credit crunch is seriously impacting the ability of companies to raise money and service their debts, simultaneously cash flow is being squeezed by customers lengthening payment terms and suppliers tightening credit lines. More than 40 percent of respondents to the survey said that the credit crunch has had an adverse or extremely adverse impact on their access to credit, and on the cost of that credit. In terms of working capital, 92 percent of companies surveyed said their customers were attempting to stretch payment terms, and 87 percent were seeing suppliers demand earlier payment of invoices. (See Chart 1.)

The knock-on effects of a tightening credit environment are multifold.

- Almost 60 percent of respondents expect investment to be restricted. 50 percent said they were delaying refinancing their debts or were having their refinancing arrangements reassessed. 43 percent said their exposure to bad debt had increased.
- Not surprisingly, almost a quarter reported that they were reducing their expenditure on buildings and machinery. *(See Chart 2.)*

Chart 1 - Have the tightening credit markets adversely affected you in any of the following ways?



"We want to get a better internal financing cash flow generated, which means working capital will be very high on the agenda in the coming years."

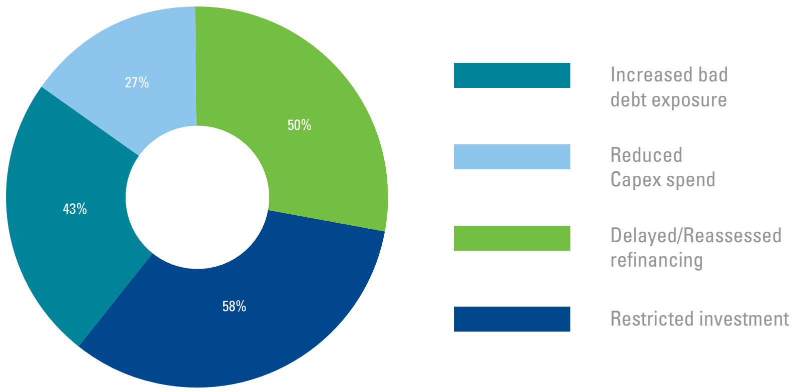
Ludwig Gold
Salzburger Aluminium AG

With demand in western economies drying up the pressure is on companies to continue to expand in fast growing markets. The shortage of liquidity in the capital markets is forcing a focus on alternative sources of cash. A fifth of respondents cited the need to expand to new markets as a factor in their decision to focus on cash performance. Take Salzburger Aluminium AG (SAG). "We are acquiring a company in Mexico, we see a good opportunity in Turkey, and we have a big project running in Russia. But all this is a lot of money, and we don't want to increase our debts, which would reduce our equity ratio," says Ludwig Gold, Head of Corporate Finance and Controlling at Salzburger Aluminium AG.

"We want to get a better internal financing cash flow generated, which means working capital will be very high on the agenda in the coming years."

For business organizations, cash means flexibility: the ability to make acquisitions, to invest in new plant and machinery, to develop new products and services, and to take on new staff. It means the capacity to absorb defaults by customers and the exposure to bad debt. It means the ability to raise credit ratings and gain improved credit terms from suppliers. And it means staying on-side with stakeholders – from banks and analysts, to large institutions and small shareholders – who are increasingly focused oncash in a period when free capital is in short supply.

Chart 2 - How do you expect the tightening credit market to impact your business in the next 24 months?



"We're buying from external suppliers in India and China and that is extending our supply chains, and we're earning two or three months of inventory in transit. We're trying to be leaner internally, but that's being offset negatively by increased inventories."

Ian Marsden
Timkens European Controller

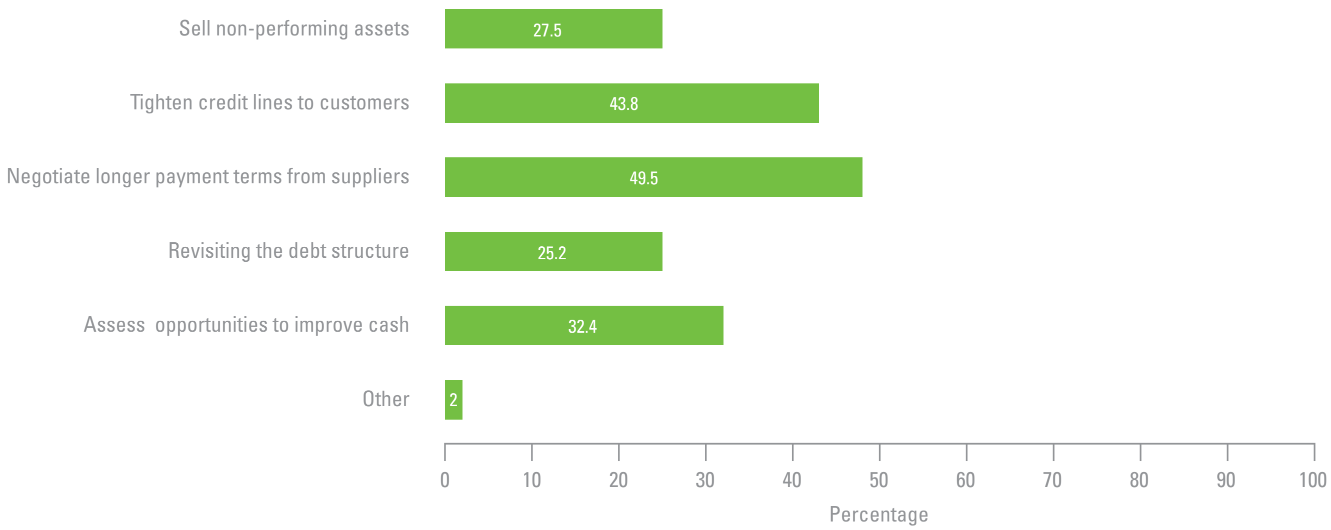
Faced with a fast-deteriorating situation, many companies are seeking stopgap solutions to raise cash quickly. Almost half of the respondents said they had renegotiated payment terms with suppliers; 44 percent said they were tightening credit lines with customers. Moreover, a quarter of companies in the survey reported that they were selling non-performing assets, or revisiting their debt structures. About a third said they were assessing opportunities to improve cash generation across their businesses. *(See Chart 3.)*

Asked to identify their most important factors for becoming more cash-efficient, the financial managers surveyed cited, in roughly equal numbers, the rising cost debt and reduced access to credit. The pressure from stakeholders – including banks, investors, analysts and credit rating agencies – also figured prominently. *(See Chart 4.)*

Not all companies are focused exclusively on the short-term drivers, however. Some, like Salzburger, are making the most of the current economic conditions to drive through fundamental change in the form of full cash improvement programs.

Indeed, the survey respondents foresee that cash performance will remain somewhere near the top of the agenda for a good while yet. That is mainly because large numbers expect economic conditions to remain difficult, with customers continuing to expect improved payment terms. Asked to identify the factors that will have greatest bearing on the cash performance over the next three years, 38 percent of respondents said stretched customer payment terms would be the most important consideration going forward.

Chart 3 - Are you doing any of the following to address issues created by the tightening credit market?

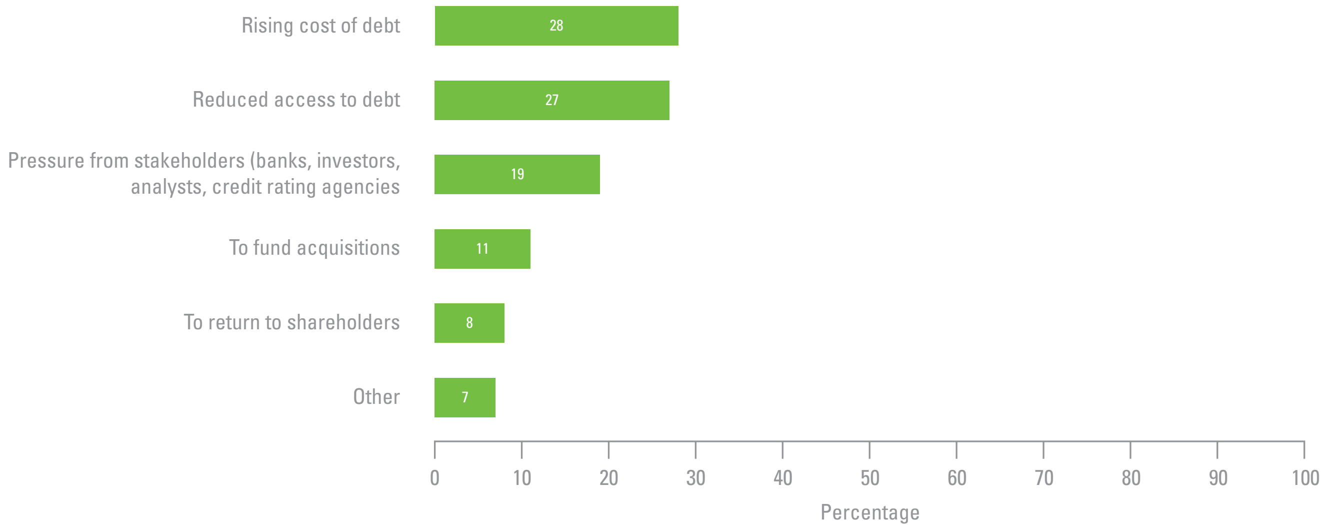


And not all the factors behind the general prioritization of cash are related to the credit crunch. Broader economic drivers are also at play. A fifth of companies surveyed said that increased lead times, resulting from the sourcing of goods and services in low-cost foreign markets, will be important to working capital management going forward.

That is certainly an issue for the Timken Company, a large Ohio-based supplier of roller bearings. Ian Marsden, Timken's European controller, says the use of plants in India and China will increasingly affect inventory-related costs. "We're buying from external suppliers in India and China and that is extending our supply chains, and we're gaining two or three months of inventory in transit. We're trying to be leaner internally, but that's being offset negatively by increased inventories," he says.

Given that 45 percent of companies surveyed are experiencing a significant increase in the cost of credit and 42 percent are seeing access to credit substantially reduced, it is no surprise that cash and working capital are so high on the corporate agenda, and it is hard to see it's importance diminishing in the near term.

Chart 4 - What typically triggers your company to increase it's focus on working capital?



Case Study 1: Working capital rises on the agenda at Salzburger Aluminium AG

For Salzburger Aluminium AG (SAG), a large, privately owned metals business based in the Austrian city of Lend, working capital was just another management agenda item until a few months ago. Important, yes, and something managers were incentivized to monitor and improve - but not a top-level priority. That's not the case any longer, however.

As Ludwig Gold, the group's head of corporate finance and controlling, explains, working capital is now a tier-one necessity that every manager is instructed to focus on. "It is very high on the agenda, because we need more liquidity for funding our projects & acquisitions. It has received high attention from our board and supervising board, because of the liquidity constraints we are facing currently on the market, and of course, the increasing financing costs we see in the financial sector."

SAG is being squeezed. On one hand, its largest customers are seeking longer payment terms for SAG's products. And, on the other, the company's financial partners are tightening terms on short-term financing. "We are a tier-one supplier to the truck industry and our customers, the who's who in the truck industry, are asking every year for longer payment terms, which is really destabilizing our working capital," Gold explains.

Increased working capital has already impacted the company's ability to expand faster into new markets. "We have had substantial growth over the last three years, but now we are at the point where we cannot grow because too much capital is tied up. If we increase our sales with the major truck producers, we have to find ways to finance 90 days in advance, for material cost, for personnel cost, and that is really causing a big headache."

In response, SAG has embarked on a comprehensive working capital improvement program, which involves better forecasting of cash flows, finding a better balance between the payment terms of its customers and suppliers, and new metrics for assessing progress. Gold thinks the program is bearing fruit, but he expects that Salzburger's board will continue to press management to pay close attention to cash management for a good few months yet. "I think the attention [on working capital] will remain high, because financing costs are increasing," Gold says.

Case Study 2:
Crunching numbers at Idaho Asphalt Supply

The US company, a supplier of asphalt to road builders across the North West, is caught in the middle between suppliers and customers.

The impact of the recent huge hikes in the price of oil has been felt across the board, but the pain is worse for some than for others. At Idaho Asphalt Supply, in the US North West, the company's finance organization has been forced to review the credit terms it offers customers as its own costs skyrocket. CFO Blair Sellers explains that the price of the company's main raw material – asphalt – has risen from US$160 a ton to US$700 a ton over the last nine months. "We are very closely tied in with what's happened with oil prices, and as a result we are very squeezed from a cash perspective," says Sellers. "It's gone absolutely absurd. So cash management and explaining all this to our bankers is a very big priority for us."

He points to the delicate balance he needs to strike with customers, most of which are involved with government capital improvement projects, and suppliers to ensure his cash flows are sufficient to finance the business.

Sellers says Idaho Asphalt's suppliers – the crude oil refiners which produce asphalt as a side product to gasoline – have substantially reduced their payment expectations, from 15-60 days a few months ago to something significantly shorter. In turn, that is likely to have severe knock-effects for Idaho's customers. "We anticipate that virtually all our supply will have to be paid for in two days. What that means for us is that instead of giving customers terms of between 30 and 45 days, we're now going to cut their terms to 5 to 7 days. The impact upon our customers, who are primarily road building contractors, is going to be enormous. I honestly believe that some businesses are not going to survive with the changes in credit terms. Typically they've been able to wait for the check and then pay us. But now they're going to have to go out and get financing, and with today's credit crunch, these contractors may not be able to find credit. So I think that could be a dramatic impact."

All of which means Sellers and his executive colleagues need more visibility on the company's cash position to manage the risk. And the CFO says measures introduced before the credit crunch hit have been instrumental in protecting Idaho Asphalt's working capital position. "We have significantly raised the level of information that we circulate among the executive team here at the company," he says. "Every week, in fact almost daily, everybody in the leadership group of the company gets a card which shows how we're doing, versus how we were doing the previous week, and where we were a year ago. Providing analysis and understanding trends, (something that the company hasn't done until just recently), has been invaluable in giving us insight into where we're going."

Section 2:
Improved visibility and control

Accurate forecasting is one of the first steps to any sustainable, successful working capital improvement, and vital for reducing an organization's exposure to financial risk. The bad news, according to the survey results, is that many companies have some way to go improving the quality of their cash forecasting.

Inaccurate or untimely data can increase the risk of insolvency, lead to organizations having larger reserve funds than required, or reduce the yields that might be accrued from cash that is not immediately required for the business. Over the past 12 months, only 14 percent of respondents said their forecast was on target, while a further 34 percent said their forecast was only within a range of 10 percent of actuality. Around a quarter reported themselves to be within a range of 20 percent of the real number, while more than 15 percent said their estimate was more than 30 percent out – a staggering statistic.

The challenge for finance organizations is to find a way to make sense of data that is frequently scattered across many parts of the business, including different locations and different IT systems. Surveys frequently find that effective data collection is one of the most significant issues facing financial managers.

At Timken Company, Ian Marsden says there is something of a disconnect between the process to produce the company's rolling cash forecasts and the other that is used to calculate numbers that are released to the outside world. "We are producing rolling cash forecasts for the next 12 months entity by entity and then consolidating those through our treasury group. Those are based on identifying particular cash needs by country or by entity. The other process is more of a corporate picture: are we going to deliver earnings, or are we going to deliver cash? Sometimes there isn't necessarily a very good reconciliation between the two," Marsden says.

Timken's finance organization has been working to update the company's enterprise resource planning (ERP) systems and so improve the management of inventory and supply chains – both vital, obviously, to working capital performance. However, Marsden says there is still some work to be done on the organization's ability to make accurate projections of its future financial position.

"The forecast and planning tool that we use is not ideal," he says. "We're a complex organization in terms of the amount of products that flow across regions and between entities. If, when we generate an accounts receivables balance in the forecast, we don't get the right mix of external sales, inter-company sales, or where those sales are going to be produced from, then you end up with fairly nonsensical balance sheet values, and the cash flow statement that is driven off that becomes fairly meaningless."

The difficulty of forecasting stems not only from the systems and procedures that are being used, but also the fallibility, motivations and priorities of the human beings involved. After all, what comes out of a system at the end of the day will only be as good as the quality of the input into the system in the first place. A vital element of forecasting, therefore, is to ensure that business units agree with the need – the necessity – to produce reliable, accurate numbers.

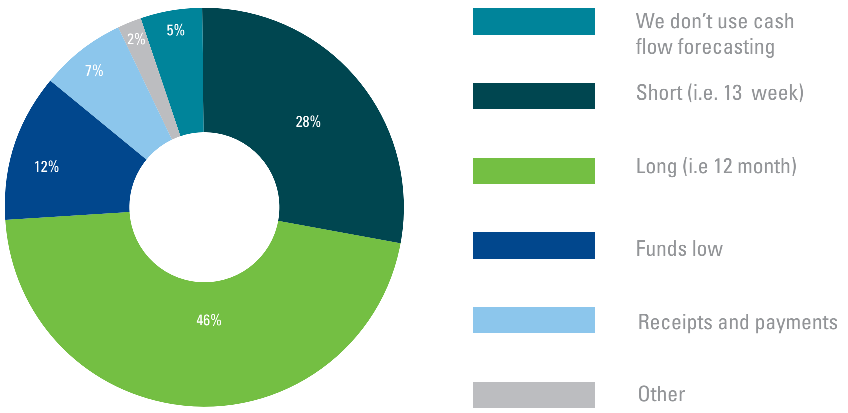
Human relationships here are key: continuous calls for numbers, and continuous challenges to those numbers, may lead to frustration among business units who feel that they are being asked to do a lot for little reward. The goodwill of different parts of the business to the finance organization's requests is key to improving the quality of the underlying data.

The issue of incentives (see next section) is part of a larger issue at the heart of improving working capital management: accountability. Rewarding managers for improved working capital efficiency is the flipside of saying that they should be responsible when things go wrong. Too often managers are not made responsible for forecasts that fall short of the mark.

Incentives are only one side of driving better practices through the organization, and only deal with the final outcome. The other side is that managers are made accountable for forecasts that turn out to be wildly inaccurate. One idea is to impress on managers the penalties for inaccurate forecasting in the shape of lost value to the company. Translating mistakes into numbers may help to shed light on their importance and encourages managers to take responsibility.

Systems and procedures *are* important, however, and the survey revealed differences in how organizations approach data collection. The respondents varied widely in the frequency with which they feel happy making cash flow projections, for example. Almost half the financial managers reported that they work on a 12-month "long" cycle for forecasting; 28 percent said they organize themselves on a quarterly 12-week cycle; and 12 percent use a "funds flow" method. Astonishingly, about 5 percent said they attempt no form of cash forecasting at all. *(See Chart 5.)*

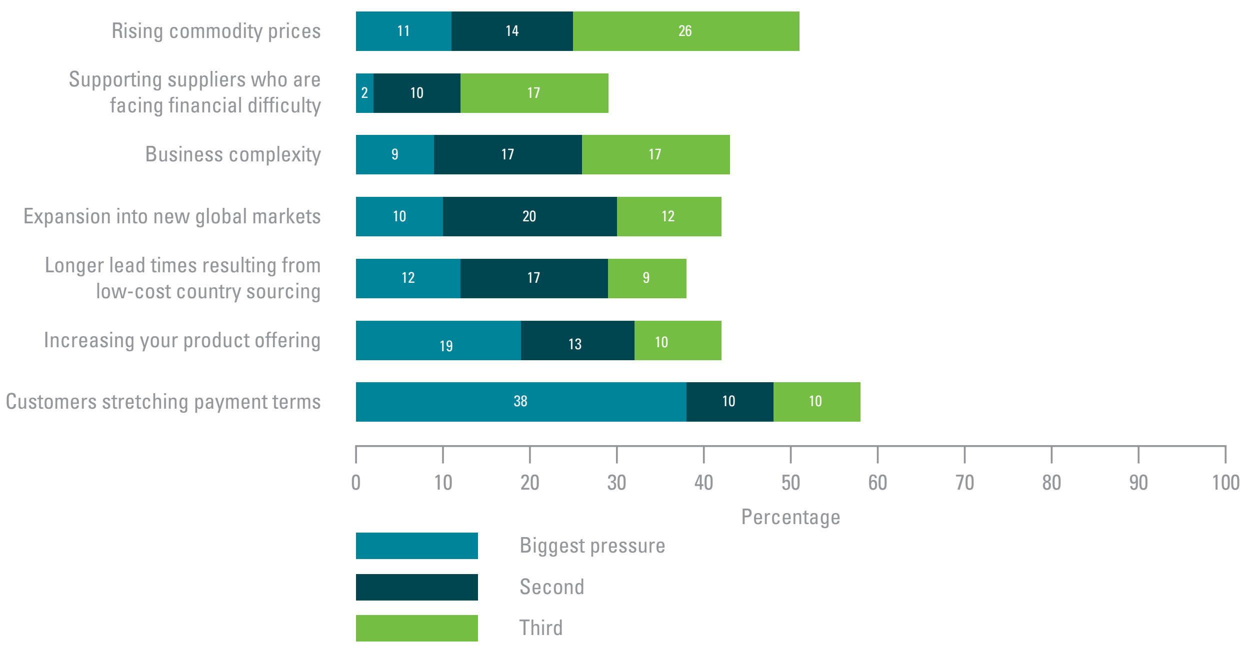
Chart 5 - Which of the following best describes the type of cash flow forecasting that your company uses?



Some companies are realizing the need to forecast their cash flows more frequently. "Before last year, we forecasted only at the end of the month, now we try to do this every day," says Maciej Strozyk, Group Controller at Eurocash, a Polish wholesaler and grocery stores chain. "Now we have a daily budget for payables, receivables and inventory, and we are almost achieving our expectations for everything related to working capital."

However, some areas – like the cost of raw materials – remain hard to forecast, irrespective of the systems or the personnel involved; more sophisticated strategies such as hedging may be required. Almost half the respondents said rising commodity prices would put pressure on the cash performance, both in the sense of limiting actual capital, and making forecasting cash flow more difficult. This is no excuse for putting forecasting in the "too difficult" section of management activity. Often companies can score large improvements in forecast accuracy in the areas that have historically been as challenging. *(See Chart 6.)*

Chart 6 - Over the next three years, what will be the top three pressures on working capital performance?



Case study 3:
Building on early success at Tele Columbus Group

A working capital project initiated last year at Germany's third largest cable operator hit its targets in four months by focusing on quick wins. The challenge now for CFO Michael Buhl is sustaining the momentum.

"When I report the monthly financial statements, their first question is usually about EBITDA performance, and the second is working capital management."

Michael Buhl,
CFO Tele Columbus Group

The project started at the private-equity owned company in the summer of 2007, just as leverage began to dry up amid the credit crunch. Tele Columbus's owners, a consortium of funds in the US, saw the end of the era of cheap credit as a chance to put working capital in the spotlight as never before.

"When it's nearly impossible to access cash externally, a leveraged private equity firm starts looking for internal sources," says Michael Buhl, CFO at Tele Columbus.

As it turned out, they didn't have far to look. One of the company's first moves was to change the payment terms on a €60 million supplier contract, from yearly to monthly. The new monthly scheme saved so much on interest (Tele Columbus had a credit arrangement to make the annual payment), that the result was up to a 40 percent reduction in working capital right off the bat.

Even without the interest payment, there are other working capital challenges. With its 2.5 million customers paying quarterly or annually, the company needs to account for cash variances of up to €50 million throughout the year. "It's very important for us to know what is going to happen when, and to make sure we have adequate financing in place to cover those peaks and those troughs," says Buhl.

To increase cash visibility, the company switched to receipts of payments forecasting. They project working capital on a weekly basis for the succeeding two years.

The technology is simple but effective. "The forecasting is in spreadsheets," Buhl says, adding, "The sophisticated numbers come from the [systems spreadsheets draw on], like CRM."

Senior managers at Tele Columbus are incentivized on EBITDA performance, and in the cable industry that's a proxy for operating cash flow. "So you can say we're 100 percent evaluated on cash flow," Buhl says.

Hitting targets after only four months was a bonus, but Buhl isn't coasting. "It's easier to reduce it once," Buhl says. "The more critical thing is to continuously monitor and track it."

Buhl is well on the way already. He gets weekly working capital reports and sits down with his team to identify potential improvements. A change to incentives for middle managers could be on the cards too – there is a proposal to link middle management bonuses to working capital performance starting in the 2009 fiscal year.

The pressure from Tele Columbus's private equity owners, Buhl believes, will only intensify.

Section 3:
Incentives and disincentives

The survey shows a strong correlation between management incentives and working capital performance, yet companies still fail to incentivize.

Companies that provide incentives fared better over the last three years, and expect to suffer less over the next three years, according to the survey results. *(See Charts 7 and 8.)*

More than 70 percent of the finance executives surveyed said incentives were slightly or very important to the success of a capital improvement initiative. Indeed, many of the CFOs we spoke to in follow-up interviews said their companies had begun to tie in incentives with working capital performance. For example, Ian Marsden, at Timken Company, said it was an important part of his company's recent efficiency drive in this area. "It's 15 percent of the total bonus opportunity, so it's based on a mix of corporate earnings performance, individual business unit earnings, working capital management and customer service," he explains.

Given the positive evidence on incentives, it was surprising that many companies either fail to incentivize for cash management or incentivize to relatively minor degree. *(See Charts 9.)* These results are at odds with the importance that many organizations claim to place on working capital. More than 80 percent of companies surveyed said that management of this area is either a "high priority" or the "highest priority". That means that upwards of 10 percent of companies say working capital is a priority but don't incentivize their managers to improve in this area.

Chart 7 - % of companies with static or improving working capital in the last three years

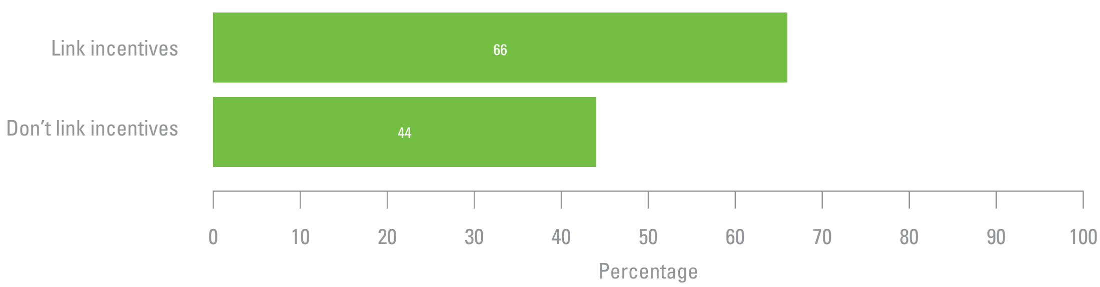
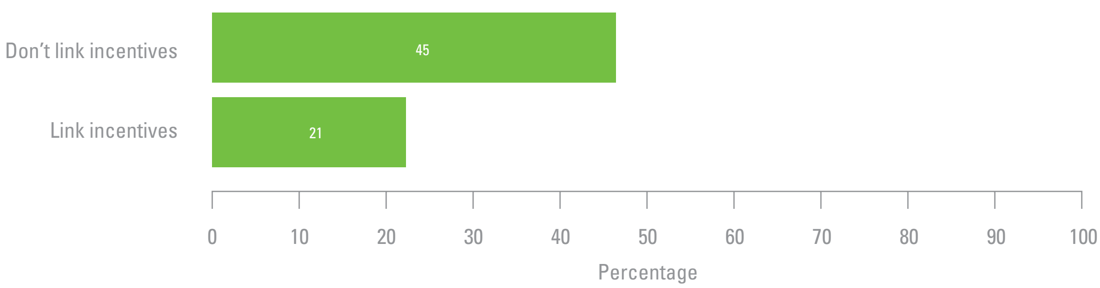
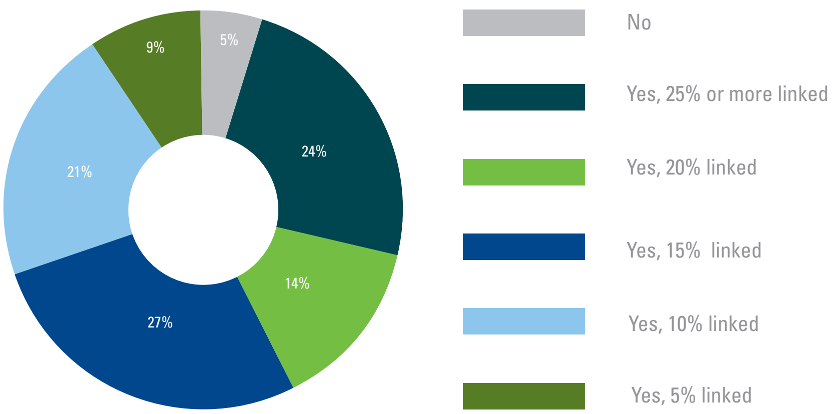


Chart 8 - % of companies that expect a deterioration of working capital in the next three years



Beyond the incentives that companies offer their senior managers is the issue of how they motivate middle and lower management to focus on working capital. In a sense, that is an even more difficult question as it goes beyond simple compensation structures to trickier questions of individual drive and priorities. The problem for organizations is that working capital and cash flow management isn't a natural part of many peoples' jobs, including those who could greatly help to improve efficiency.

Chart 9 - Are cash flow targets part of the management teams' incentives package at your organization?



Maciej Strozyk at Eurocash says that while the company has improved the performance at the upper end of the organization, the rest of management remains an issue. "It's a priority for the general directors, of course," he says. "But with middle management, it depends. For some of the operational managers, and the logistics managers, it's a major priority. Good inventory management is one of their fixed objectives. But of course it's not so important for sales, though it's supposed to be one their targets."

This is where metrics become important – so that the wider business is aware of how well the organization is performing in terms of working capital.

Since it started to focus working capital earlier this year, Salzburger Aluminium AG has instituted a number of measurements of its progress. "In January this year we started calculating days payable outstanding and days of inventory and stock on a monthly basis," says Ludwig Gold. "Based on our latest forecast we have given targets to the management team in all our subsidiaries, so that we really see if they're making progress or not. We have targets that we check on a monthly basis. Based on our latest forecasts we will not fully achieve our targets, but we will be better than last year, and I think that's the most important thing."

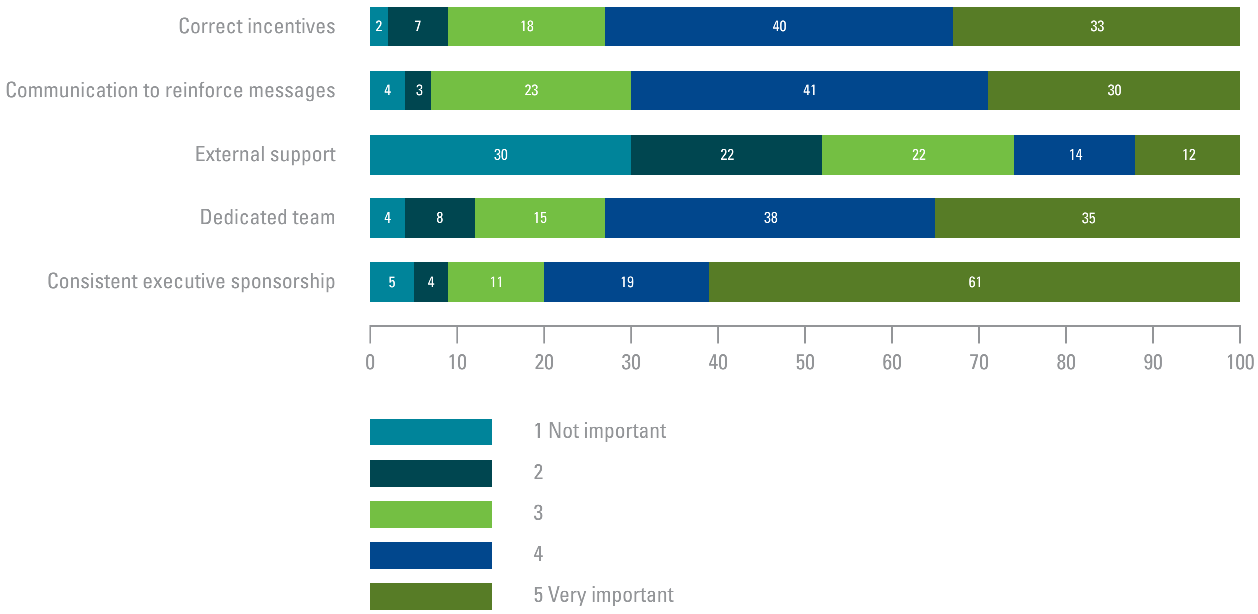
Section 4:
The route to continuous improvement

While accurate visibility and control are among the key foundations of better working capital management, managers cannot afford to stop there. The survey finds that other, less tangible, factors are almost as important, including executive sponsorship and communication.

Two other factors were also seen as important, including having a team dedicated to the program's goals (35 percent rating this very important) and aligning working capital goals with departmental and individual goals (40 percent seeing this as very important). The last result chimes with what the survey revealed about the importance of incentives and the interplay between the needs of the organization and the employees.

However, communication and executive sponsorship were given greater weight by the survey respondents. More than 60 percent described consistent executive sponsorship as "very important" in achieving a positive result to a working capital program. Another fifth said it was somewhat important. Meanwhile, in excess of 70 percent of CFOs surveyed said communication to reinforce messages through the company was very or somewhat important.
(See Chart 10.)

Chart 10 - How would you rank the importance of the following factors in achieving a positive result from your working capital program?



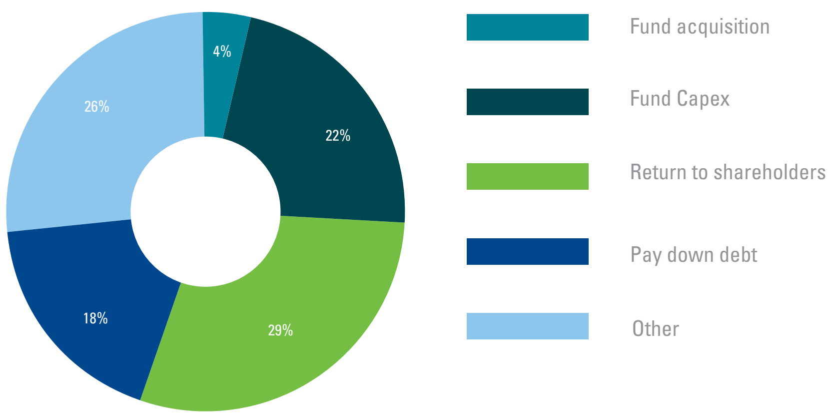
"We have raised significantly the level of information that we circulate among the executive team here"

Ian Marsden, at Timken Company, says a focus on persuading managers lower down the chain of command to pay attention to working capital has borne some fruit.

"In response to rising receivables, we've put a lot of effort into improving our processes," he says. "It's not just between us and the customer. It's also some internal issues that can affect customers' ability to pay. We've done a lot of work on trying to improve that and just within some of my sphere within Europe, we've released quite a lot of cash, which has gone into paying down debt."

According to the survey, just over a quarter of respondents intend to use the cash, like Timken Company, to reduce debt. The uses of working capital, however, are fairly evenly distributed.
(See Chart 11.)

Chart 11 - Which of the following best describes how you use the cash released from your working capital program?



Adopting the right approach to human capital is vital to achieve sustainable cash and working capital improvement.

Simply understanding that communication, executive sponsorship and incentives are important doesn't necessarily lead to improved performance in these areas, however. Far from it. In fact, the research reveals that respondents feel these factors are among the most difficult to get right because they are "people-related" and involve the sort of consistent attention that is difficult for managers to sustain over a long period.

Indeed, the survey finds that it's vital not to overlook the human element surrounding better capital management. While driving forward company-wide improvements is a laudable goal in itself, it must be accompanied with an empathy and sensitivity for the positions of various business units. Often these units will not share the same priorities as more senior management – or the same incentives. It is therefore up to management to communicate clear instructions about the importance of cash forecasting, along with straightforward tools allowing employees to participate.

Ludwig Gold, at Salzburger Aluminium AG, says the biggest change to have taken place as a result of the company's recent working capital initiatives has been cultural. "The biggest change was to the sales team and that is where I've received the most feedback," he says. "Previously the sales people did not feel as much responsibility (for working capital). Now, after what we did, we have had a great achievement since last December reducing the amount of overdues. Every week the sales person gets a report about his customers and overdues. The first question was: why should I look at that report every week? And we told them, we need the money as soon as possible, and not just at month end. It was really a cultural change, not only going to the customer and bringing good news and selling products, but also making them taking responsibility for cash collection."

Section 5:
Conclusions

Though the credit crunch may not feel like a blessing for finance departments, it does present an opportunity to push through reforms to how companies manage their working capital. With cash in short supply, now is the time to consider installing the processes and procedures to sustain improvements to working capital performance over the longer term. Once normality returns, and credit is available again, the temptation will be to revert back to bad habits. The task for many finance departments in the years ahead will be to try to ensure that doesn't happen.

Achieving sustainable improvement over the long term requires cash management to become a natural part of every day life for everyone in a company. This means the cash flow impact of decisions is considered in addition to the sales and/or profit effect. That targets, reporting and incentives all have cash and working capital elements. Roles and responsibilities for cash and working capital are clearly defined across the business, and the right policies are in place to govern behavior.

Visibility and control of cash flow is also a vital step to creating the right framework for managing cash. According to the survey, this is where many organizations are failing at present. Only 14 percent of respondents said their cash forecasts were on target over the last 12 months. The inaccuracy of forecasts is only part of the problem, however. Many companies don't use the metric as a part of their assessment of operational cash performance. And they fail to get buy-in from business units outside the finance organization. To make forecasting more accurate, managers should ensure that they establish a clear reporting format, define who is accountable for reporting the relevant numbers (this is not just finance), and challenge and review submissions to encourage continuous improvement. It is only through this sort of focus that organizations can hope to improve a crucial aspect of their working capital performance.

Given the recent credit crunch and the ensuing economic uncertainty, it is understandable that finance organizations merely do what they need to do to get through the next week, month or quarter. Tightening payment terms and refusing to extend credit, for example, are perfectly reasonable reactions to a crisis. But they won't serve the longer-term requirements to improve how companies manage cash flow. There are a host of longer-term reasons to focus on cash flow, including opportunities in emerging markets, the renewed focus by credit agencies of firms' internal capital flows, and the growing complexity of business organizations, which tends to breed more inefficiency and tie up more cash rather than less.

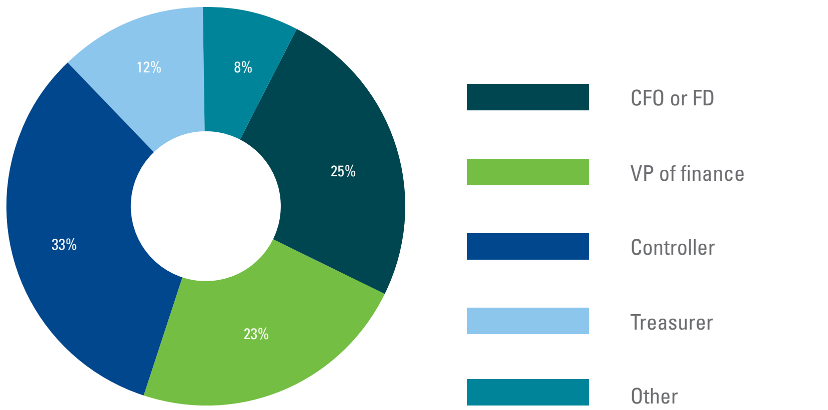
The key is to attend fastidiously to detail – to the processes, policies, and people that define cash and working capital performance. Focusing on the cash cycle across functions and seeking to ensure a timely and accurate flow of information is critical to enable rapid responses to market conditions. The finance organization needs to engage all parts of the business, driving awareness of the importance of cash and working capital management. Without alignment across all functions finance will merely be reacting to challenges as they arise rather than proactively planning how to manage issues with minimal business disruption. Given the speed and severity of the slowdown in economic performance companies should be acutely aware of the risks related to the financial health of their own customers and suppliers. Sales and purchasing need to maintain active dialogue with customers and suppliers to assess the potential risks and finance needs to be engaged to manage exposure.

Cash and working capital are set to remain high on the corporate agenda. The winning companies will release cash from their businesses to provide financial flexibility, and use this opportunity to embed cash into the culture and maintain a healthy balance between cash and earnings when economic prosperity returns.

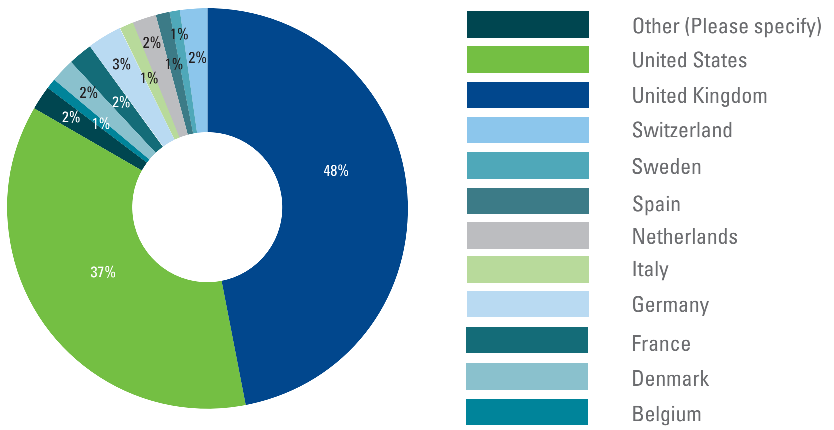
Demographics

A total of 556 finance executives were surveyed by CFO Europe research services through an online questionnaire during 2008. Almost every major industry is represented. Here is further information about the respondents.

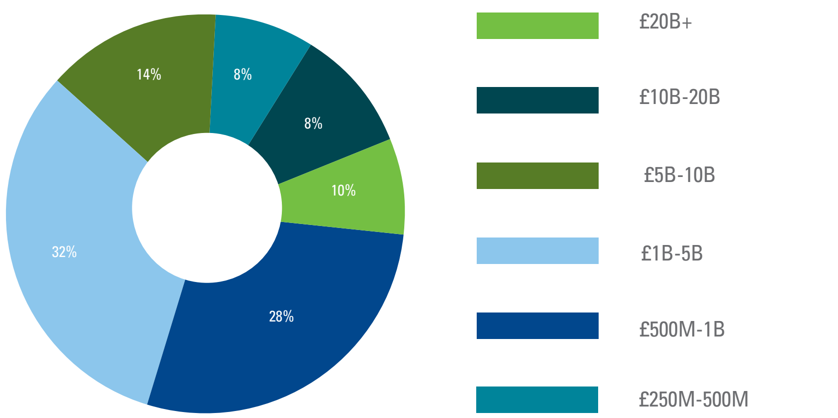
Job title



Location



Revenue



kpmg.com

For more information, please contact:

Roger Bayly
Partner
KPMG in the UK
Tel: +44 (0) 207 694 6424
roger.bayly@kpmg.co.uk

Andrew Ashby
Associate Partner
KPMG in the UK
Tel: +44 (0) 207 694 3231
andrew.ashby@kpmg.co.uk

Brad Hillier
Managing Director
KPMG in the US
Tel: +1 404 222 7239
bhillier@kpmg.com

Peter Wiegand
Partner
KPMG in Germany
Tel: +49 30 2068 4348
pwiegand@kpmg.com

Jacqueline Bongartz
Director
KPMG in the Netherlands
Tel: +31 20 656 8311
bongartz.jacqueline@kpmg.nl

Cyril Schlup
Director
KPMG in France
Tel: +33 (0) 1 5568 6094
cshlup@kpmg.com

Federico Bonanni
Partner
KPMG in Italy
Tel: +39 045 815 7611
fbonanni@kpmg.it

Angel Martin Torres
Partner
KPMG in Spain
Tel: +(34) 91456 3400
amartin@kpmg.es

Giulio de Lucia
Partner
KPMG in Switzerland
Tel: +41 44 249 30 60
gdelucia@kpmg.com

Fergal Power
Director
KPMG in Hong Kong
Tel: +852 3121 9844
fergal.power@kpmg.com.hk

Designed and produced by KPMG LLP (UK)'s Design Services.

Publication name: The future of cash

Publication number: RRD-107520

Publication date: November 2008

Printed on recycled material.