

Cash and Working-Capital Discipline

**CFOs at midsize firms face
their top financial challenges**

A report prepared by
CFO Research Services
in collaboration with
American Express



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About this report

For more than 10 years, CFO Research has conducted an annual study among CFOs of midsize firms to explore the issues that matter most to them. In their earliest incarnation, these studies focused closely on expense management, to help midsize firms make the most of their valuable resources. In the aftermath of the recent financial crisis and the depths of the downturn, we studied the immediate tactics midsize companies were using to gain access to liquidity and fund their operations. As the economy began to show its first signs of turnaround, we asked CFOs at midsize organizations to assess their responses to the downturn. And last year, in *Winning Strategies in the Emerging Recovery*, we explored midsize companies' search for robust growth and prosperity in a challenging recovery.

As we followed midsize companies and their progress through dark economic times, finance executives' fierce determination and competitive spirit shone through at every turn. When they looked to the future in *Winning Strategies*, finance executives found strength in the core finance disciplines that had seen them through the downturn: investing and spending wisely; avoiding waste; promoting financial self-reliance; and acting as good stewards of value, control, and compliance.

One of the great truisms in finance is that cash—the most fundamental measure of value—is king. In this year's study, therefore, we chose to expand on our earlier findings by exploring financial discipline—and, in particular, cash and working-capital discipline—more deeply. What challenges do midsize firms currently face in the management of their cash and working capital? What are their priorities and plans for improving their cash and working-capital management in the coming months? We surveyed 325 senior finance executives at midsize companies to find out.

Title

CFO	55%
Controller	18%
VP of finance	11%
Director of finance	7%
EVP or SVP of finance	3%
CEO, president, or managing director	2%
Finance manager	2%
Treasurer	2%
Other	1%

Revenue

\$250 million to \$500 million	8%
\$100 million to \$250 million	21%
\$10 million to \$100 million	71%

Industry

Auto/Industrial/Manufacturing	19%
Wholesale/Retail trade	16%
Business/Professional services	10%
Public sector/Nonprofit	9%
Financial services/Real estate/Insurance	7%
Health care	7%
Food/Beverages/ Consumer packaged goods	6%
Hardware/Software/Networking	5%
Construction	5%
Media/Entertainment/Travel/Leisure	4%
Chemicals/Energy/Utilities	4%
Aerospace/Defense	4%
Transportation/Warehousing	2%
Pharmaceuticals/Biotechnology/ Life sciences	2%
Telecommunications	1%

KEYS TO WORKING-CAPITAL IMPROVEMENT Diligence

“Diligence is key to improving working capital management—key to running a successful business. You must focus on both sides of the working-capital equation, and your improvement efforts have to be top-to-bottom in the organization. It’s difficult to do, but it can change your company.”

—CFO OF A MIDSIZE WHOLESALE/RETAIL TRADE FIRM

Creating a secure foundation for growth

When ready availability of credit evaporated in the recent financial crisis, midsize companies lost little time in becoming more financially disciplined. They slashed costs and paid down debt at a ferocious pace, while working to eliminate excess inventory and improve collections in a competitive buyer’s market for goods and services. Nearly four years later, the results of this year’s survey suggest that financial discipline has become a way of life for midsize firms. Eighty-five percent of survey respondents confirm that their companies are more financially disciplined—that is, more able to maintain a lean cost structure, a strong balance sheet, and optimal levels of cash, working capital, and liquidity—in the aftermath of the recent downturn. (See Figure 1.)

This accomplishment is doubtless a source of satisfaction not just within the finance function, but across the enterprise. But maintaining this level of discipline isn’t easy, and many finance executives anticipate some trouble doing so in the year ahead. Although more than one-third of all respondents (34%) say that maintaining financial discipline will become easier in

the coming year, an even greater share of respondents (41%) say they expect it will become more difficult.

Of course, that kind of difficulty may be just the sort of problem that midsize companies will be glad to have: maintaining financial discipline often becomes more difficult when growth picks up. Personnel across the company have less time to focus on the intense demands of financial discipline when they’re working to fill a growing number of orders with downturn-depleted resources. But growth can also stretch working capital as urgent spending and investment needs outstrip companies’ immediate ability to convert inventories and receivables to cash—which means that cash and working-capital discipline becomes, if anything, even more important during growth periods. So it’s not surprising that finance executives seem to think that the effort of maintaining financial discipline will contribute to competitive advantage over the next year outnumber those who say it will limit competitive advantage by more than three-to-one. (See Figure 2.)

Finance executives at midsize firms do recognize that maintaining financial discipline carries a degree of risk—in particular, the risk of underinvestment at a critical juncture in the recovery, leading to a long-term

Figure 1. Financial Discipline Since the Recent Downturn

The vast majority of survey respondents report that their companies are more financially disciplined in the aftermath of the recent downturn.

My company is **currently _____ financially disciplined**, compared to the period before the recent downturn.”

- Much more
- Somewhat more
- Somewhat less
- Much less
- It depends
- No change

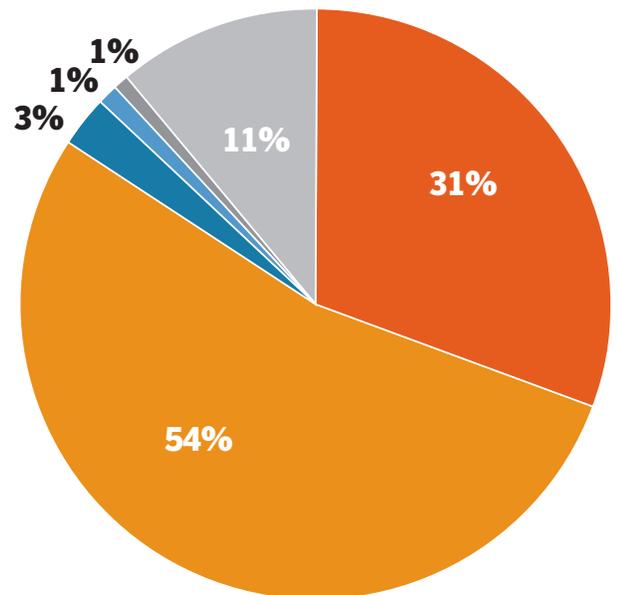
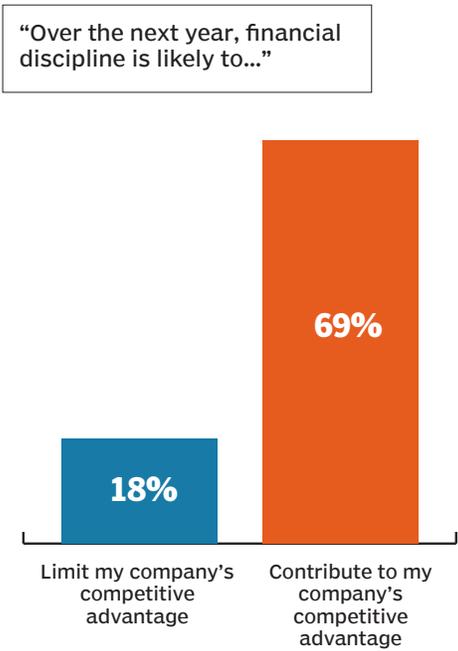


Figure 2. Financial Discipline and Competitive Advantage

Respondents who say that financial discipline **will contribute** to competitive advantage outnumber those who say it **will limit** competitive advantage by more than three-to-one.



Note: 6% of respondents answered “It depends,” and 8% said “Not sure.”

competitive impairment. But the experience of the downturn has also taught many midsize firms that maintaining a relatively conservative financial position can yield valuable benefits. In a difficult business environment, the most valuable of those benefits may well be increased financial flexibility and control, because these help companies—even those with limited borrowing capacity—to respond quickly to changing business circumstances. As midsize firms prepare themselves to face an environment of fierce competition, price volatility, and continued economic uncertainty, a secure financial foundation is not a luxury—it’s a necessity.

Constant pressure on working-capital improvement

Diligence—not innovation—is the essence of working-capital improvement. The finance executives who participated in this study emphasize consistency, focus, and continual engagement as keys to better cash and working-capital management. “I don’t think there are any silver bullets here,” one CFO told us. “It really is the basic blocking and tackling.”

Survey results suggest that midsize firms have been blocking and tackling a lot in recent years—working hard to extract payments from increasingly distressed customers, negotiate more favorable terms with suppliers, and reduce inventory levels while maintaining overall margins. A solid majority of respondents report that their companies are in a stronger working-capital position today than they were when the recent recession took hold: two-thirds of respondents report that their companies’ days-working-capital (DWC) position today is better than it was three years ago. Effort applied to collections was the primary contributor to this improvement; respondents are much more likely to report improvement in days sales outstanding (DSO) over the past three years (56%) than they are to report improvement in days inventory outstanding (DIO) (41%) or days payable outstanding (DPO) (42%). (See Figure 3.)

KEYS TO WORKING-CAPITAL IMPROVEMENT

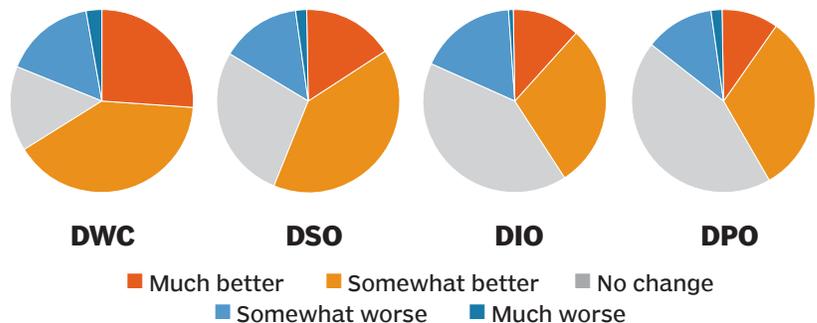
Consistency

“Have an honest conversation with your vendors about the need to extend payment terms. Then never miss a payment date.”

—CFO OF A MIDSIZE NONPROFIT FIRM

Figure 3. Current Working-Capital Position vs. Three Years Ago

A majority of finance executives report improvement in their overall working-capital position. Improvements in inventory and payables positions lagged, however, behind improvement in receivables.



KEYS TO WORKING-CAPITAL IMPROVEMENT (Smart) focus

“Focus on the largest buckets of cash—not necessarily the biggest problem areas.”

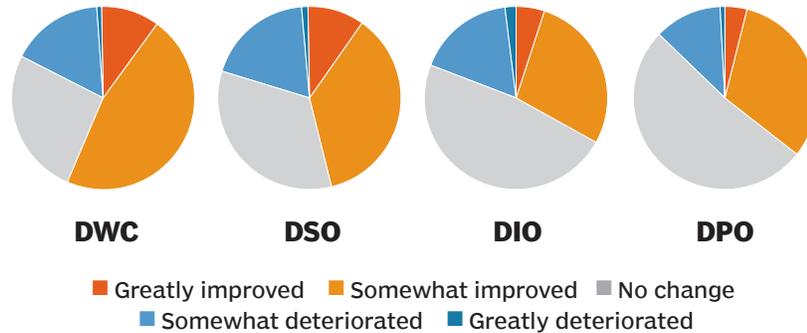
—CFO OF A MIDSIZE PROFESSIONAL SERVICES FIRM

“Keep a keen eye on the details: due dates on payables and regular progress reports on receivables throughout the reporting period.”

—CFO OF A MIDSIZE FINANCIAL SERVICES FIRM

Figure 4. Change in Working-Capital Performance over 2011

Improvement in DSO, in particular, led to overall improvement in working capital performance.



Even over the course of the past year—a year that followed on the heels of many months of concentrated working-capital improvement effort in the aftermath of the financial crisis—many midsize firms were able to achieve further gains. Across the survey population, respondents who report improvement in days working capital (DWC) over the past year outnumber those who report deterioration by a wide margin. (Fifty-six percent of respondents report improvement in DWC over the past year; only 17% report deterioration.) Again, improvement in collections led the way: respondents report improvement in days sales outstanding (DSO) over the past year (47%) much more often than they report improvement in days

inventory outstanding (DIO) (33%) or in days payable outstanding (DPO) (36%). (See Figure 4.)

As they strive to improve in the coming months, midsize companies are likely to continue focusing their efforts on receivables performance, followed closely by better inventory management. (See Figure 5.) It should be noted, however, that relatively large numbers of respondents report “no change” across the three main dimensions of their working-capital performance in the past year. These results suggest that there aren’t very many easy (or even not-so-easy) gains left to capture—which means that many midsize firms are likely to find it difficult to continue to register working-capital improvement in the coming months.

Figure 5. Working-Capital Priorities

Receivables performance and inventory management surface as high priorities for improvement. A fairly large number of respondents decline to choose just one area, saying they plan to focus on “all three” equally.

“Of the three main dimensions of working capital, _____ will be the highest priority for improvement at my company over the next year.”



Note: 3% of respondents answered “Not sure.”

Lack of bargaining power: A challenge for midsize firms

The intense scrutiny that midsize companies are applying to their receivables flows from a simple fact: when business conditions deteriorate and a buyer's market for goods and services develops, the ability to convert receivables to cash suffers. Customers become better able to bargain for favorable terms in addition to lower prices—and less concerned that late payment will jeopardize their ability to do business with their suppliers. When new orders are scarce, “the customer is always right” is a slogan that takes on a whole new level of urgency for companies battling to preserve their market share.

Bearing in mind that every company engages in two kinds of transactions—buying and selling—it stands to reason that companies seek relief from the pressure they feel on the sales and collections front by extending payments to their own suppliers and vendors, creating a ripple effect of more-robust collections efforts and extended-payment negotiations throughout the broader population of firms. Indeed, analysis of *CFO* magazine's annual working-capital scorecard

shows exactly this trend: across the population of large companies that the scorecard monitors, DPO/payment performance tends to deteriorate as DSO/collections performance improves.*

These forces are certainly predictable, but they don't affect every company equally. A few companies in every size and industry cohort will always find ways to buck the broader trend and achieve working-capital gains on both the order-to-cash and the procure-to-pay sides of the equation. But the results of our survey show that midsize firms are systematically at a disadvantage compared with large companies—simply because large firms, with their vast buying power, have a degree of bargaining clout that their smaller counterparts lack.

First, our survey results confirm that midsize companies most often do large volumes of business with companies larger than they are. (See Figure 6.) Survey respondents also frequently note that larger companies aren't hesitating to exercise their bargaining power, to the detriment of midsize companies' ability to convert receivables to cash. (See Figure 7 on page 8.)

Meanwhile, a plurality of respondents (44%) admit that they have difficulty requiring their suppliers to accept modifications in payment terms. (See Figure 8 on page 8.) At the same time, those who agree that increased

KEYS TO WORKING-CAPITAL IMPROVEMENT Speed

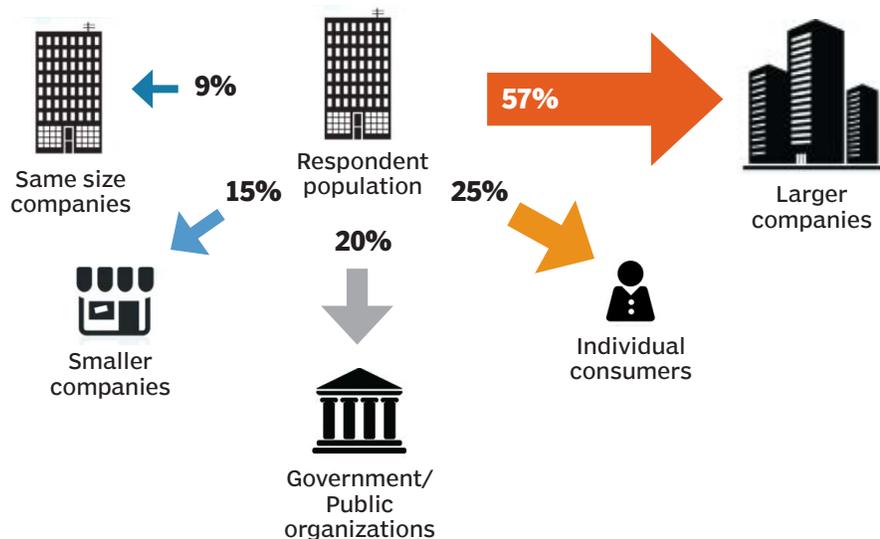
“Develop a weekly routine of positive communication with customers relating to accounts-receivable aging status. If you identify quality problems with your deliverables, develop an instant feedback loop between the customer and your quality control, sales management, operations, and finance functions so that quality issues are addressed in the first 10 days of aging—not when the account is past due.”

—CFO OF A MIDSIZE AEROSPACE/DEFENSE FIRM

*For more information on the trends we've identified in *CFO* magazine's annual working-capital scorecard, please see *Distinguishing Cash and Working Capital Management* (July 2009), available for download at www.cfo.com/research.

Figure 6. From which customer segments do companies derive a large volume of business?

*Firms most often derive a large volume of business from other companies that are **bigger** than they are.*



KEYS TO WORKING-CAPITAL IMPROVEMENT
Engagement

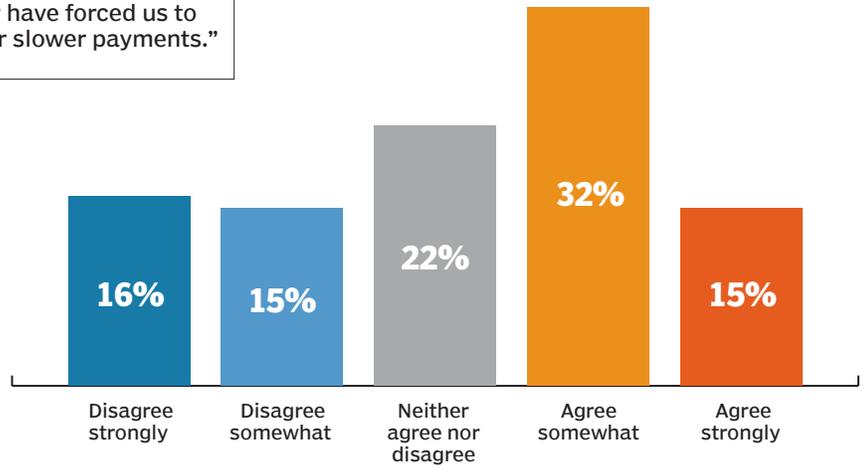
“Create internal agreement on how to increase cash flow and increase understanding of why cash flow is important to the company as a whole. Generate buy-in from the sales force and other internal stakeholders.”

—CFO OF A MIDSIZE MANUFACTURING FIRM

Figure 7. Large Companies Flex Their Bargaining Muscle

Respondents who agree that larger companies have used their bargaining power to force them to accept slower payments outnumber those who disagree by a wide margin (47% versus 31%).

“Over the **past three years**, my company’s **ability to convert receivables to cash** has **suffered** because larger companies with more bargaining power have forced us to bear the burden of their slower payments.”

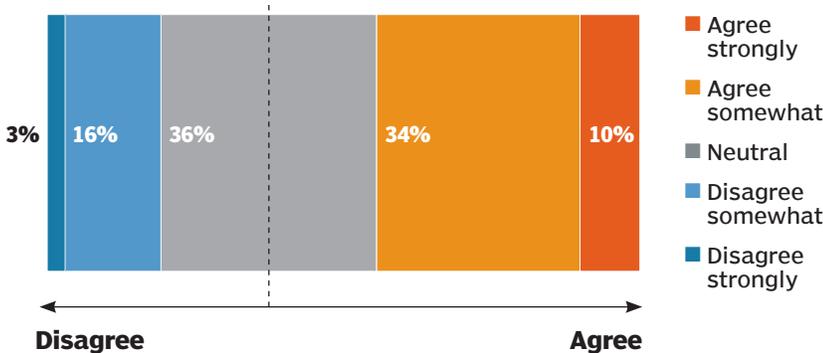


Note: 1% of respondents answered “Not sure.”

Figure 8. Do midsize firms have difficulty persuading suppliers to accept changes in payment terms?

In general, yes: A plurality of respondents (44%) agree that they have trouble requiring suppliers and vendors to accept changes in payment terms. Far fewer respondents—only 19%—disagree with that statement.

“Even when my company holds a negotiating advantage, we have difficulty requiring our suppliers and vendors to accept changes in payment terms without damaging our credibility—or their financial position.”

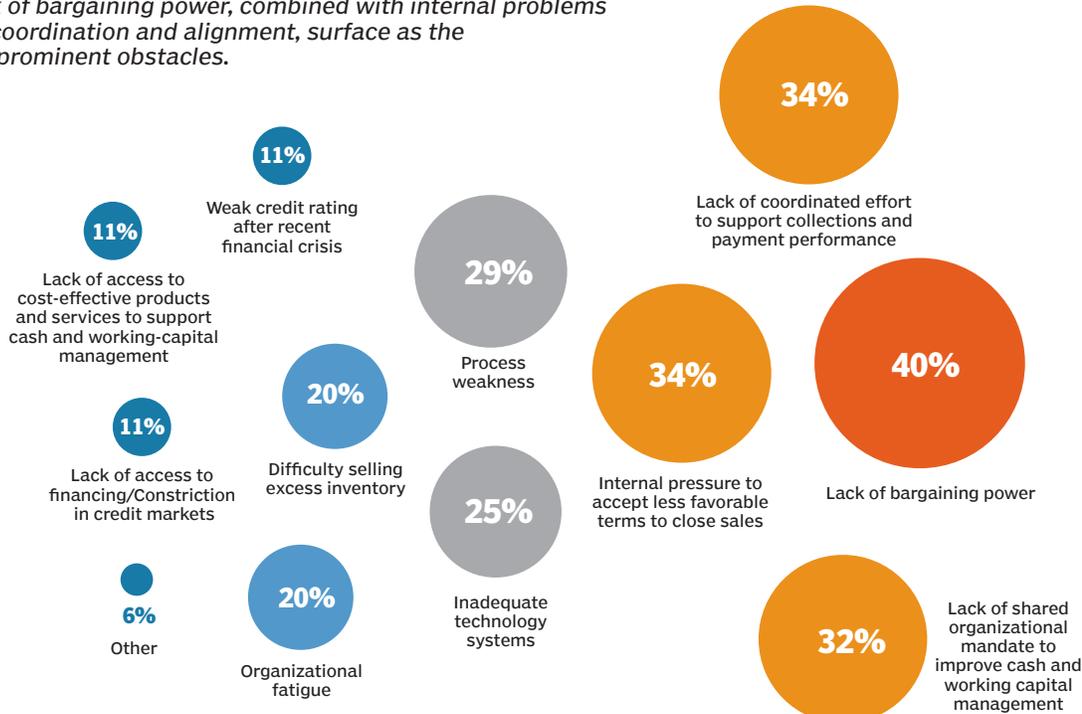


control over payments would yield a meaningful improvement in working capital (48%) outnumber those who disagree with that proposition (19%) by more than two-to-one.

Taken together, these results suggest that a lack of negotiating leverage places midsize firms at a disadvantage not only when they seek to collect briskly from their largest customers, but also when they look for more favorable terms from their own suppliers and vendors. Midsize companies’ working-capital accomplishments in recent years seem even more impressive when viewed in this broader context. Until the economy returns to robust growth and demand for goods and services rebounds strongly, however, midsize organizations can expect that their relative lack of bargaining power will continue to complicate their efforts to free cash on their balance sheets in the months to come.

Figure 9. What stands in the way of cash and working-capital improvement at small and midsize companies?

A lack of bargaining power, combined with internal problems with coordination and alignment, surface as the most prominent obstacles.



Note: Respondents were asked to choose up to four barriers.

KEYS TO WORKING-CAPITAL IMPROVEMENT
Accountability

“Develop measurable objectives—hold employees accountable for achievement across the organization.”

—CFO OF A MIDSIZE HEALTHCARE FIRM

Many hands make light(er) work

What other obstacles do midsize companies face as they work to improve their cash and working-capital management? We asked respondents to evaluate a wide range of potential barriers. The ubiquitous “lack of bargaining power” surfaces as the most-often cited problem. But survey results reveal that organizational and cultural issues—including lack of coordination, internal pressure to accept unfavorable terms, and lack of a shared organizational mandate for improvement—follow close behind. Indeed, as barriers to cash and working-capital improvement, organizational and cultural matters edge out both process weakness and technological inadequacy by a narrow margin, and they far outstrip financial matters like weakened credit ratings, credit constriction, or lack of access to affordable financial products and services. (See Figure 9.)

Because organizational and cultural problems emerge as some of the most substantial barriers to better cash and working-capital performance, we might expect midsize firms to make cultural and organizational change a centerpiece of their improvement efforts. But survey results show something different: when asked to assess four major improvement categories, respondents most frequently report that process improvement will play a “major” or “supporting” role in their plans (84%), followed by increased automation (71%). Cultural and organizational change follow distantly (55% and 50%, respectively). (See Figure 10 on page 10.)

Viewed together, these results suggest some intriguing questions: are respondents relying on process change as a precursor for organizational or cultural adjustment? Put another way, are better, more streamlined and standardized processes seen as a useful (or even necessary) framework for further change? Can process improvement serve as a mechanism to influence company culture or organization (as opposed to a

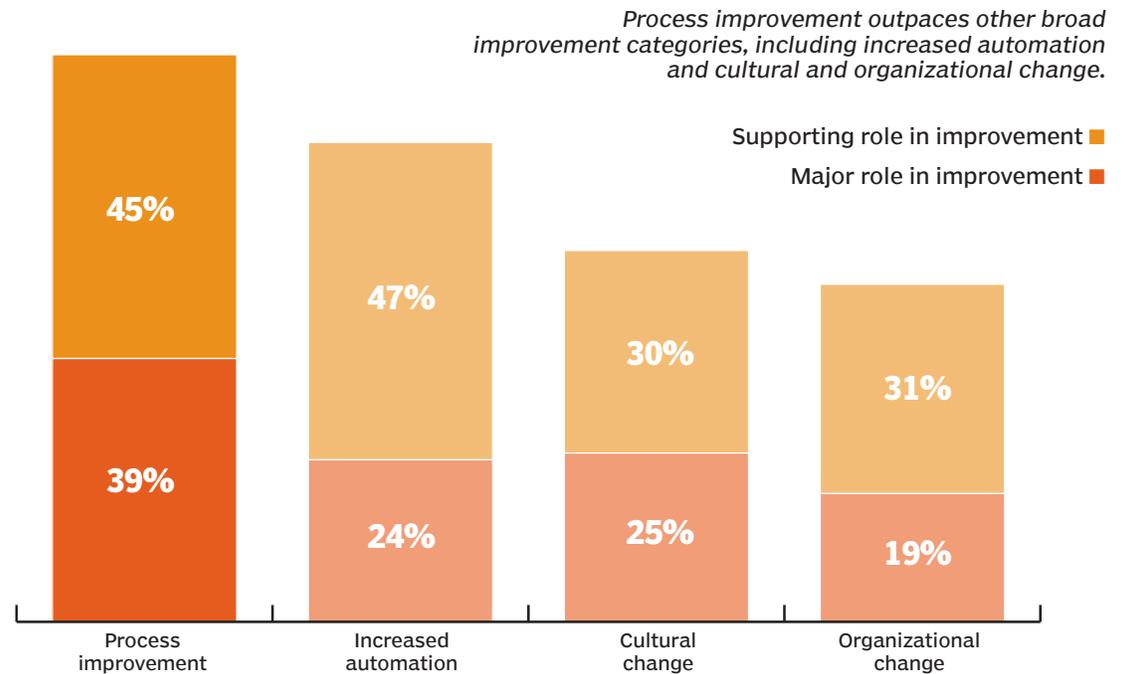
KEYS TO WORKING-CAPITAL IMPROVEMENT

Fiscal conservatism

“If you strengthen your balance sheet, you can get the operating cash you need (i.e., if you’re profitable, make very limited distributions to shareholders). Bad times are coming—see the problems with the Euro!”

—CFO OF A MIDSIZE CONSTRUCTION COMPANY

Figure 10. What broad types of cash and working-capital improvements will small and midsize firms pursue?



mere expression of a firm’s culture and organization)? Or is process improvement simply a worthy—but also a less-challenging and more-comfortable—substitute for tackling amorphous (and recalcitrant) cultural and organizational problems?

We plan to explore these questions, among many others, in our ongoing research on cash and working-capital improvement at midsize companies. This report is the first of several from this year’s research program among midsize companies. For now, perhaps the main conclusion to draw from these survey results is this: effective cash and working-capital management is the work of the whole company—not the work of finance alone. Coordinated, cross-functional effort—especially among finance and account-relationship holders across the organization—is one of the most reliable paths to improvement.

Those working in sales and operations have tremendous influence over the day-to-day decisions that can have a profound impact on a company’s working-capital position. At the same time, it comes as little surprise that the daily demands of closing deals and filling orders

can sometimes edge out working-capital considerations in resource-strapped sales and operating units. But the finance executives who participated in this study agree that encouraging decision makers to factor working capital into their thinking can make a difference. “Don’t underestimate the benefits to be realized from educating those in the organization who have customer or vendor contacts on the importance of cash and working-capital management,” writes the CFO of a midsize professional services firm in response to an open-ended question.

Ultimately, executives say, the issue is one of finance leadership: creating a cash-conscious culture, setting expectations, measuring progress, and insisting on accountability. “Implement a ‘cash is king’ philosophy across the board,” writes the controller of a midsize manufacturing company. “Hold key management personnel accountable for their operations.” Senior finance executives know that there’s no magic bullet for cash and working-capital improvement. But they also know that following fundamental management principles—like ensuring that those who have *control* over cash and working-capital-related decisions are also *accountable* for the consequences of those decisions—can work some magic of its own.

Sponsor's perspective

To get through the recession, mid-market companies were forced to adopt a more disciplined approach to financial management. Nearly four years later, financial discipline has become a way of life for these companies. They understand the importance of a strong balance sheet, and that having sufficient cash on hand gives them financial flexibility and improves their ability to respond to an ever-changing marketplace.

Maintaining such a strong level of financial discipline over time isn't easy. As growth increases, and spending and investment needs put pressure on a company's cash reserves, it becomes more important to manage working capital effectively. American Express partners with thousands of mid-market companies to help them achieve their expense management goals. From negotiating better payment terms with suppliers to finding new ways of improving their cash flow, we work with companies to ensure they are in a strong financial position, so they're prepared to compete in today's unpredictable business environment.

Optimized Working Capital

By leveraging the American Express billing cycle, companies can pay suppliers more quickly while keeping their cash longer. This not only optimizes their working capital, but improves supplier relationships. This is particularly valuable to midsize companies, which have less bargaining power than their larger counterparts.

Greater Savings

Our suite of corporate payment solutions help companies consolidate spending across businesses and geographies, and then provide detailed data and reports so they can successfully track their spending. This increased information and visibility gives companies additional negotiating leverage with suppliers, which ultimately drives savings to the bottom line.

Expert Advice

American Express serves more than 70% of the Fortune 500 and thousands of midsize companies. We provide world-class relationship support and have one of the largest client management teams in the industry. Our dedicated account teams partner with clients to provide customized analysis of their spending patterns and behaviors—they mine data for valuable insight, discover new opportunities to improve cash flow, and provide expert advice on how to be more strategic about spending.

For more information about American Express Global Corporate Payments, please visit www.americanexpress.com/corporate.



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