

Why It's So Hard to Manage Cash By Alastair Dryburgh

"Cash is King", or so the saying goes. If that's true, then sometimes cash is like King Umberto II of Italy, who ruled for little more than a month in 1946 before being exiled. In 1947, the Italian constitution barred him and his male heirs from ever setting foot in Italy again.

This white paper is not about techniques for managing cash more effectively; I and others have written about that elsewhere. It's about why those techniques, which are about as far from rocket science as it's possible to get in business, seem to be so inconsistently applied. In practical terms, it explains what you have to do before you can start applying the techniques.

It's a Trade-Off

Remember the old saying "good, cheap, fast – choose any two?" If you want a good job done fast, it won't be cheap. If you want a good job done cheaply, it won't be fast.

There is a similar trade-off between revenue, profit and cash. If you want to maximize revenue without affecting profit, one popular way to do it is to sweeten the deal with longer payment terms. Or maybe you hold higher stocks to make sure that you never lose a sale because an item is out of stock. Both of these expedients have no effect on the profit and loss account but damage your cashflow. Similarly, if you want to improve your margins, you can probably reduce costs by buying in larger quantities, or manufacturing in longer runs. Again, the impact on the profit and loss account is wholly and visibly positive, but the effect on your cashflow is negative and largely hidden.

The Problem with Trade-Offs

The way many trade-offs are handled is:

1. People don't notice them, deny that they are necessary, believing that they can have the best of both worlds, or just decide to ignore them. The result is that:
2. Tradeoffs are made by default, or by accident.

Once you have identified that this is the source of the problem, it's not hard to see how to deal with it.

Trade-offs are made at the day to day operational level, each time a sale is made or a purchase order placed or a production run planned. They also occur at the strategic level, in the overall design of the business.

Trade-offs at the Operational Level

It's not that difficult to see when you are making a trade-off. Any time you do anything that has an impact on revenue or profit, identify the cash impact as well. There are many, many areas, for example:

- Length of payment terms to customers;
- Stock levels set to ensure continuity of production or supply;
- Purchase quantities decided to minimize unit costs;
- Production runs set to maximize efficiency, at the cost of high stock levels;

Dealing with Cash Trade-offs at the Strategic Level

The traditional business planning or budgeting process works like this:

1. Set the level of revenues;
2. Massage the costs to produce an acceptable profit;
3. (And a pretty poor third, at that) Work out the cash requirements and assume that they can be met.

Think about all the business plan or budget meetings you have ever been in, and the percentage of time spent on revenues or profits. Has it ever been less than 90% ? That doesn't leave much time to look at cash.

Reverse the process. Start with cash. How much cash do you have ? What can you do with it ? The answer to the second question is always "more than you first thought." Apply the same level of intensity, ingenuity and creativity to economizing on cash as you do to minimizing costs and you will be surprised at what you can achieve.

The (Often Malign) Power of Incentives

Incentives are often a big part of the problem. Take three examples:

Salespeople have to make sales. The level of discounts is carefully controlled, but the length of payment terms may not be. I came across one software company where payment schedules for new licences could stretch out three years into the future. The revenues were reported in full when the contract was signed, so the horrible effect on cashflow was very well hidden.

Buyers need to keep items in stock. This means that they need to be in constant dialogue with sales to get the latest forecasts, and able to call on the goodwill of suppliers when they are caught short. Alternatively, they can just maintain huge stocks.

Buyers need to keep unit costs down. That means that they need to negotiate effectively, choose the best suppliers, maintain multiple sources and generally work very hard. Alternatively, they can just order in huge quantities. I once met a product buyer who wanted to place an order for four years' usage of one item, because that was the minimum order quantity from that supplier.

I'm not criticizing these people. If you criticized them, I would defend them. Why? Because *they were doing exactly what senior management wanted them to do*. They were given incentives and objectives based on sales revenue, unit cost of purchased goods or availability of stock. Of course meeting those objectives meant behaving in a completely dysfunctional way and causing major problems for the organization, but that's the fault of senior management.

Education, not Control

How do organizations get people to do what they want? Usually it's by incentives and control. Reward them when they do what they are supposed to, try to prevent them doing the wrong thing and whack them if they do break the rules. The famous behavioural psychologist B F Skinner found that this worked really well for conditioning behaviour in pigeons, and Pavlov had a lot of success with dogs, but you have to query whether the approach works well with humans, especially when you are asking people not simply to maximize one variable, but to make sophisticated tradeoffs between several variables.

Think instead about educating people. Help them see beyond their own area, be sure they understand what senior management is trying to do, show them how their behaviour impacts on the results of other departments'.

Think about sharing information. If everyone is responsible for managing the trade-offs between revenue, profit and cash, everyone needs to know what these are. If your finance director spends time obsessing about this issue (as they should!), that thinking needs to be shared. How much information do you share?

Traditionally in many companies cash hasn't been managed with even a fraction of the intensity applied to revenue and profit. Until two years ago, this wasn't a problem – capital was cheap and plentiful. That's no longer the case, and thinking needs to change.

Alastair Dryburgh is head of Akenhurst Consultants