Improving Operating Cash Flow

A key variable from a financial point of view is operating cash flow as defined in the cash flow statement:

Operating cash flow = CF +/- change in Net Working Capital

CF stands for gross cash flow, which we generate from the income statement, and which simplified basically stands for:

Net Income + Depreciation

(practitioner method)

When stated more specifically, it includes net income plus all non-cash charges minus all non-cash income. In addition to depreciation, the exact calculation includes changes to provisions. I will focus solely on the practitioner method in my explanation of the calculation of gross cash flow. The change in net working capital (again simplified) stands for:

The increase/decrease of Accounts Receivable, Inventory and Accounts Payable

(analogous to the items in the cash flow statement)

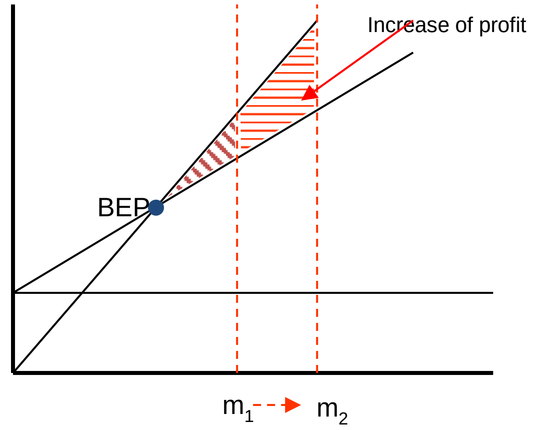
Operating Cash Flow Management

A key question is how operating cash flow can be increased. The answer is: turnover up, costs down!

We can distinguish four main approaches for achieving an increase in cash flow in practice:

1. Increasing revenue
2. Improving margins
3. Reducing fixed costs
4. Reducing the balance sheet

1 Increasing Revenues



Let us start with the most important discipline in financial management: increasing revenue or generating an increase through a higher quantity of sales (the subject of increasing prices is dealt with in the chapter Margin Improvement). Compared to
cost reduction programs, which are ubiquitous and often include the obvious measures, achieving a sustained sales increase is one of the greatest and most difficult challenges a company faces. I take my hat off to every salesperson, whether for clothes, equipment, services, or infrastructure projects, because selling is and will remain the most important and decisive task at a company. Even if exciting new products are developed in the development department (and even if they are perhaps actually needed), it is ultimately the market that will decide whether they will be successful or not, and thus whether or not the company has a future

What can be done in practice to increase revenue? How are these approaches to be evaluated?

Exploiting Customer Potential

Let's say you already have customers and they are also satisfied with what you have to offer. It would then make sense to get more out of your business with them.
First: You have to nurture the customer relationship.

Second: Define your steady customers. Which leads us to the question: What are steady customers? They don't necessarily have to be those with whom you generate the most turnover. Instead, your core customers are those who have remained faithful to your company over the long term. One of my steady customers is the first company that gave me jobs while I was on my way to becoming an entrepreneur some ten years ago, and which has since given me assignments on a regular basis. They aren't the biggest jobs, but they come regularly, and this has led to a level of trust that allows for an exchange of information and concerns that might otherwise not occur in a business relationship.

Third: Utilise a professional and effective key account management system. I have often dealt with this concept, and I have observed the following problems:
Not really adequate Executives were invariably selected to supervise key account management units. These people could provide little or no added value due to their lack of skills in dealing with customers. Basically, all they did was forward the queries and concerns of customers.
At the same time, the most capable and versed employees were often assigned key account management tasks, but these individuals had no decision-making authority in their units and were therefore always at the mercy of the whims and quirks of their supervisors, which was also not in the interest of the customer.
Moreover, when capable executives were assigned key account management duties, it eventually turned out that the managers were so much in demand both internally and externally that they never lasted long in their positions and instead moved on relatively quickly. Consequently, customers constantly had to deal with different people.

Fourth: Communicate with the customer, but make sure you don't overdo it.

Acquiring New Customers
This is the most difficult task in a company - it's the entrepreneurial challenge par excellence. What good is innovation or solid financing if you can't sell products or acquire customers?

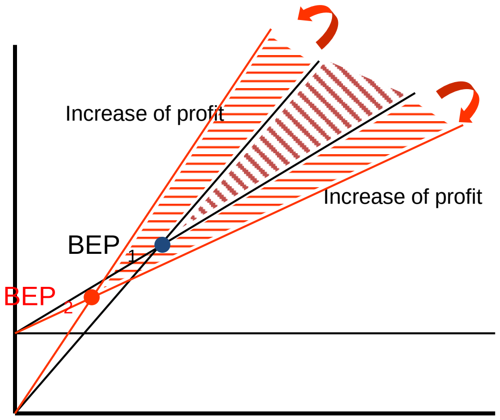
Optimizing Sales Staff Performance

Years ago, I was an absolute fan of variable compensation systems with high performance based components in line with the motto "Success should be rewarded properly". After all, in such a setup, everyone profits - i.e. both the company and its sales personnel.
Today I think differently. I would more strongly link compensation to the overall results of the company, rather than to the performance of the individual, and I would also ensure that the fixed portion is attractive and that sellers therefore don't have to worry about paying the bills at the end of the month. The motivation to deliver performance does not depend primarily on wages, but rather on recognition, the existence of a positive and harmonious working environment, job security, and advancement and development opportunities.
Performance must be measured in a timely manner and the response must be quick if performance declines or disappears completely. Insufficient seller performance can lead not only to financial damage but also to significant reputational or other damage.

Holding on to Customers

Coddle your customers. Do good things for them and do them often and intensely because customers mean turnover and they're also the best, cheapest and most credible advertisers your company could ever hope for.

2 Improving margins



Now that we've covered revenue increases in terms of quantities sold, we turn to prices and variable costs.

Saving on Purchase

Suppliers are not lemons to be thoroughly squeezed to reduce our costs or increase our margins. You can also reduce costs without spoiling the fun the supplier has doing business with you.

That pooling and comparing can be effective instruments for negotiating favourable conditions are a well-known fact. It's also understandable and even imperative in some cases that one would permanently try to reduce costs. Often this represents nothing more than passing on the pressure one faces to the next link in the chain, or attempting to share the pressure. However, you should not take action at the expense of suppliers because your actions won't pay off in terms of your total cost position.

Reducing Discounts

This and the next approach are among the more challenging in practice. This is where creative and innovative companies distinguish themselves from less creative enterprises, and it's also the point where future margin developments are determined.

If granting discounts is common practice at your company, ask yourself why this is the case. The answers will likely be similar: industry conditions, incentives, etc. Now turn it around and ask yourself what would happen if you no longer granted discounts. We must not forget that 2-3% on the top line of the income statement - i.e. gross revenue - can have a significant effect on the final result. I am not suggesting that discounts should be eliminated everywhere. My observation is simply that they are often granted too frivolously and without good reason.

Imposing Higher Prices

When was the last time you increased your prices?

Product differentiation is a common method for effectively implementing higher prices. Here, you start with a simple, relatively low-priced standard model, but you then raise the price considerably after you add a new feature, even if it's not all that much different than the standard variant in terms of its function or design.

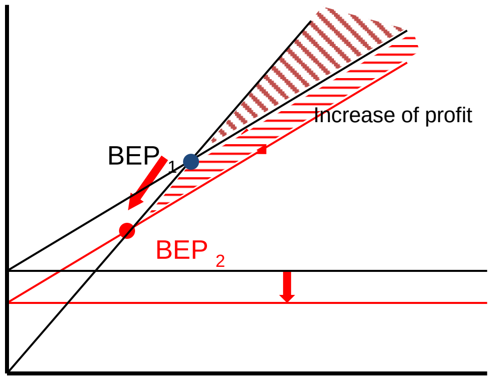
Or else you surround your product with all kinds of services. Such all-inclusive packages usually produce a sweet result when you analyse not only prices, but also your margins.

A little more challenging, but also more sustainable, is a price increase implemented in the wake of an innovation.

When paired with a skilful brand and image strategy, the whole thing can become a true success story. If you can label your great product with an equally great brand, you'll get a standing ovation.

A portfolio or product shakeup is both an incentive and a pain for the sales department because from its point of view, there's always a reason why a particular product or part should not be removed from the lists and disappear from the warehouse. One does not immediately have to take all slow-moving products with low margins out of a portfolio. However, one should focus on product ranges that generate high margins. In a nutshell, it comes down to concentrating on profitable products and services.

3 Reducing Fixed Costs



Reducing General and Administrative Costs

This is a classic because at first glance, lowering personnel costs through layoffs or the reduction of salaries is considered the most effective method here. Certainly there are situations where this is inevitable. Companies have also become much more consequent than was the case years ago.

However, processes can also be optimised and rationalised. Perhaps certain benefits could be eliminated as well.

Reducing Standby Costs

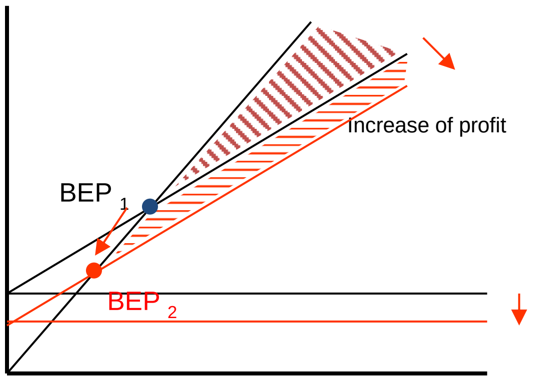
It makes no sense in the long term to carry excess capacities, which means they should be reduced wherever this is appropriate and reasonable. Reserved spaces/rooms can be eliminated or sold, and further cost savings can be achieved through technology adjustments.

Establishing Direct Links Between Revenue and Costs

References in this connection would be, for example, outsourcing, just-in-time production, reduction of warehousing facilities and part-time employment.

The goals of such programs are obvious. However, what is sometimes underestimated is the “collateral damage” that can impact the company - e.g. loss of know-how, dependencies, quality problems, lower margins, reputation damage, increased substitutability from the customer’s point of view, etc. That’s why it’s important to think through such decisions and calculate their impact.

4 Capital Expenditure Optimisation and Management of Net Working Capital



Basically, this involves the financial and accounting implications of the levers described above. In other words, and to emphasise a different aspect, there can be no reduction in capital expenditure if corresponding business measures are not implemented. The initiative is often taken by the Finance & Controlling department, where someone might point out that an average credit period of 120 days for customers is a sign that the company is now operating more like a bank than an industrial enterprise. If management don't find this great and exciting, action will have to be taken. So, the salespersons will then be sent out to shorten the payment periods and collect debts. This reduces the receivables portfolio and thus the balance sheet. The ratio of turnover to capital improves. However, optimization can also be taken too far. For example, it is common for controllers at companies to keep a permanent eye on stock and encourage those responsible to keep it as low as possible. Perhaps, however, it is strategically smarter to keep a high level of stock, which enables you to deliver at any time and promptly fulfil your customer's every wish. Thus, the opposite may be advantageous - you just have to be able to finance it.

There are also additional opportunities to make improvements on the liabilities side. For example, expensive money can be replaced with cheaper money, but this might come at the expense of stability and independence and thus lead to greater volatility.

An essential part of **operating cash flow is the change in Net Working Capital**, which - simplified - includes accounts receivable, inventory and accounts payable. These three elements are commonly considered to be directly related to revenue, and thus business development. If revenue increases, it is expected that the three balance sheet items will also increase, and vice versa. However, sometimes things operate the other way around in that turnover declines and Inventory and accounts receivable increase; this is generally referred to as a crisis.

Companies underestimate the financing of Net Working Capital, sometimes quite considerably. When revenue is generated and a profit reported in the income statement, then everyone is happy. All too often, however, things will then get a little crazy. That’s because the CFO or Treasurer will have to work extra shifts in order to keep the ship on course, as a lot of liquidity will now be needed to finance the growth.

Many a proud ship has been wrecked on such refinancing cliffs, or stranded on the banks of accounts receivable and inventory. It’s a thriving company, and it is truly regrettable to see it crash into the rocks. Liquidity planning is the means to prevent such dismal fates.

5 Summary

Operating cash flow management means addressing and actively **managing the most important flow in the water system, the cash flow generated from operating activities**.

Management options here include the three operational issues of revenue growth, margin improvement and reduction of fixed costs. **The first two are more sophisticated and proactive in terms of management activity and quality.** Reduction of fixed costs is a defensive, sometimes unavoidable measure.

The financial and accounting dimensions become an issue when optimising the balance is the goal. Of course, technical accounting improvements can be made without underlying operating steps such as the sale of accounts receivable. However, any improvements made here usually aren't sustainable. **Basically, balance optimisation is a consequence of operational improvements.**

In terms of practical implementation, this can mean better exploitation of customer potential, preventing the loss of customers as much as possible, optimising seller performance and acquiring new customers. All of this is rather demanding, especially the acquisition of new customers.
Margin improvements may be achieved through price increases, the granting of fewer discounts and better-negotiated purchasing conditions. Fixed cost reductions often affect the links between cost and turnover and lead to a reduction of standby and overhead costs.