THE PROACTION GROUP LLC

Identifying Operational Opportunities to Reduce the Order-to-Cash Cycle During Due Diligence

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This is the fifth article in our series on Identifying Opportunities to Improve Operations. We have divided the opportunities to increase the market capitalization of a company into seven value-lever buckets.

For each area, we describe the signs we look for that indicate a company can improve its financial performance.

The Seven Value Levers include:

1. **Throughput**. Can we increase the output of a plant, office, service location, or other facility?
2. **Variable Costs**. Can we reduce the costs directly tied to our volume and revenues?
3. **Fixed Costs**. Can we reduce the costs that do not change in the short term, based on customer demand?
4. **Order to Cash Cycle**. Can we shrink the time between investment on our part and collection from our customers?
5. **Pricing**. Can we collect more revenue for the services we are providing?
6. **Asset Utilization**. Can we increase inventory turns, the use of plant equipment, or the use of facilities?
7. **Risk**. How can we reduce risks related to running our business?

In this article we share with you the signs we look for that indicate a company may be able to decrease the net working capital they need to run the business. The clock starts when the company buys raw materials and pay workers; the clock stops when they collect money from customers and the money is available to them in their bank account. From a results perspective, we are looking for indications that our client can:

- Reduce Inventory / increase turns
- Minimize days sales outstanding (DSO) in accounts receivable
- Eliminate delays tied to billing errors, billing delays and processing
- Minimize the elapsed time between the customer placing an order and invoicing
- Eliminate any order-entry errors
- Minimize lead times tied to order processing, engineering, design, manufacturing, picking and packing, shipping and invoicing.

Indicator	What it can mean
Does the company have a designed approach to determining which customers and SKUs are stocked (make to stock) and which are only made to order?	If a company turns their inventory six times per year, then they are paying for raw materials and are paying for the labor 60 days before they ship to a customer, on average. If we extend payment terms with suppliers, that will ameliorate the situation. If the company does not develop stocking plans and set inventory levels based on segmented data, then the return on investment and the delay in recouping the investment may be unbalanced and inconsistent.
Do payment terms with suppliers reflect the order to cash cycle for the company?	Does the company pay suppliers faster than customers pay the company? In conjunction with the other sourcing indicators, this can point to the need to develop and implement a sourcing strategy. In many industries it is common to have suppliers share in the real cost of capital in serving customers.
Does the company have any inventory programs with suppliers?	In the article on variable costs we explored sourcing approaches that indicate opportunities to reduce variable costs. In addition to managing variable costs, value-added sourcing agreements can provide for inventory programs, consignment inventory, smaller minimum order quantities, block scheduling, demand forecast and production schedule sharing, and other terms that can reduce inventory. In some cases, we may not reduce the amount of inventory we have to carry, but we can shift some of the inventory to our suppliers' financials.
Does the company issue credit memos more than 1 percent of total sales?	If the company issues credit memos due to inaccurate billing, then there is an opportunity to improve the invoicing process. Inaccurate billing leads to audits, reviews, and other delays. With a basic system and adequate management attention, this should rarely happen.
Does the company have more than two weeks of raw material inventory?	Two weeks is an arbitrary number. However, it is a good question to start with. While there are exceptions for long lead-time items and for items with significant freight costs, we would look for tireless efforts to receive inventory as close to the need as possible.
Does the company turn inventory among the top performers in their industry?	We cannot collect revenues from a customer we have not invoiced. As noted above, every day an item sits in inventory, it is not being invoiced to a customer. Since "good" inventory turn levels vary by industry, comparing the company to competitors provides a good benchmark.
Does the company utilize real-time tools to issue and monitor customer credit?	Weak credit processes can increase bad debt expense and allow customers to "borrow" more money than they can reliably repay within negotiated payment terms. If a company uses manual methods to check credit, they are unlikely to be consistent and diligent. The tools exist today to apply pre-designed credit rules to customers based on their actual payment track record.
Is the lead time to approve a new customer more than two hours?	If the process to check credit and set up a new customer is cumbersome, we can expect that significant effort will be put into avoiding or shortcutting the process.
Are days of sales outstanding (DSO) in accounts receivable better than industry norms? Is DSO at or below target for the company?	After a sale is made and the customer is invoiced, the company has decided to rely on the customer's ability and habit to pay as negotiated on a timely basis. If the company does not track DSO, if they are above their target levels, or if they take longer to collect than other companies in their industry, then there is an opportunity to improve.
Are shipments invoiced the same day?	Any delay in invoicing after the goods leave our dock or the services are provided indicate the controls are not in place to ensure we minimize our working capital requirements.

Indicator	What it can mean
For health care companies, negative answers to any of these questions indicate opportunity:	Healthcare companies have a much more complex set of issues related to invoicing and collections. The following questions highlight areas where the company may have an opportunity to better emulate high-performing companies. • Are invoices submitted to the primary payor within 24 hours of service? Some circumstances, like needing to collect certificates of medical necessity, doctor signatures, and other supporting documents can delay billing by weeks. If, however, there is a delay, we need to investigate. • Are less than 5 percent of bills rejected or denied by the clearinghouse and insurance company? • Are insurance coverage, demographic data, co-pay and deductible levels verified at time of service? • Are bills sent to payors electronically? • Can the company receive electronic Explanations of Benefits (EOBs) • Are payments posted within 24 hours of receipt? • Are all denial reasons coded and charted to drive root-cause analysis and corrective action?

Here are some recent historical examples of working capital reductions that sprouted from observing indicators like those described above.

- For one healthcare provider, improvements in billing accuracy and collections led to a year-over-year increase in collections of allowable revenues of over six points (going from 87 percent to 93 percent). EBITDA increased by 6 percent of revenues due to this improvement.
- A consumer-products manufacturer renegotiated with their packaging supplier and reduced inventory by 80 percent. Not only did this reduce their working capital requirements, but it also led to a dramatic reduction in excess and obsolete inventory.
- A distributor of truck components and kits increased turns from 15 to over 24 within six months of taking action after identifying the opportunity to improve. This reduced their working capital outlay period by almost two weeks.
- A B2B company implemented online customer credit management tools (see www.forseva.com for more information) and they slashed their new customer setup time, reduced their bad-debt expense, and reduced DSO.

There are many examples like these. Look for these indicators. When you find them, it is time to investigate and take action!

In our next article we will look at indicators that a company can charge more for the goods and services they sell to their customers. What signs indicate that the company can increase revenues through targeted, strategic pricing changes, policy changes, and SKU management?

If you have any questions or requests, please feel free to contact me at tvm@proactiongroup.com.

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