CHAPTER 2

CASHFLOW REENGINEERING AND MANAGEMENT PRINCIPLES

THE **GOAL** OF LIFE IS LIVING IN AGREEMENT WITH NATURE.

Zeno (335-263 BC)

MY **OBJECT** ALL SUBLIME

I SHALL ACHIEVE IN TIME

TO LET THE PUNISHMENT FIT THE CRIME.

Sir W.S. Gilbert (1836-1911)

Cashflow reengineering focusses directly on the most essential element of any business: **CASH**. The "cashflow timeline" involves all the cash activities of your organization and the information that drives or is driven by those activities. Using financial management procedures to reconfigure events along the timeline can help optimize internal processing as well as indicate areas where outsourcing to vendors, particularly banks, would be more efficient. Techniques include:

Time Value of Money ("Present Value")

Gross Margin Analysis

Scenario Impact Analysis

A Formalized Bidding Procedure for Outsourcing.

This chapter introduces six of a total of **Ten Management Principles** that explain organizational behaviors which lead to business problems.[1] These principles are consolidated in Chapter 11 into four themes:

the Organizational performance, or "O" problem,

the analytical Process, or "P" problem,

the Quantification, or "Q" problem, and

the financial Reengineering, or "R" solution

Improvements in an organization's performance are functions of O,P,Q and R, as I will demonstrate with cases drawn from our consulting experience.

Cashflow reengineering improves income statement and cash position by maximizing operating results and managerial performance. While it does address various balance sheet accounts, it does not restructure the balance sheet through the use of bank credit instruments, or public debt or equity. Obviously, a strong financial position directly correlates with access to credit and equity markets; it's my experience that modern organizations must improve the former before expecting lenders and investors to participate in the risks and rewards of a business. (I use the term "business" in its older, traditional sense of any purposeful activity or endeavor, referring to not-for-profit organizations as well as for-profit corporations).

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[1] Principles VII - X are discussed in Chapter 3.

The "Under-Managed" Cashflow Timeline

A typical organization, profit or not-for-profit, operates with two elements essential to all its activities: **cash** and **information**. Much of the information in any organization is connected with a cash event. Cash that is received or disbursed is usually preceded by information (an invoice for the sale of goods or services), or is followed by information (application of payment against an open receivable).

In the traditional scheme of corporate management--sales, manufacturing, finance, information systems--no one manager has direct responsibility for these cash and information activities. The only situation in which one manager may have such oversight is in a decentralized organization with many strategic business units (SBU's), and those organizations, as we shall see, have numerous other fallacies. Most often the only common "manager" for all of the cash and information activities is the CEO or chief operating officer, who never, in my experience, has knowledge of or interest in the specific functioning of those activities. Yet cash is the lifeblood of any organization, and is arguably its most critical asset.

In order to better understand and analyze cashflows, you can prepare a "**payment stream matrix**" listing cash/information flows by name, dollar volume, and manager (see Table 2-1). The matrix becomes a kind of road map to understanding and improving your enterprise by indicating those major activities which drive the organization to short- and intermediate-term successes and failures.

(TABLE 2-1: Illustrative Payment Stream Matrix)

A "cashflow" is an activity of the organization which generates a cash inflow or outflow. Inflows, or collection flows, are often products or services; outflows, or disbursement flows, are accounts payable (to vendors for purchases), payroll, and other uses of cash. The term "mechanism" refers to the cash process normally used for the flow; as we encounter each process later in the book, it will be fully described.

Constructing the payment stream matrix may require the help of personnel from various other disciplines within your organization. It's usually necessary to involve managers in all of the functional areas of the business, including sales, operations, and finance. It may also be important to include branch office personnel to account for transactions initiated in the field and sent on to headquarters for further processing. Even input from customers and vendors can be helpful in understanding how a transaction occurs from their perspective, and to make the process more efficient and effective for all parties.

Individual managers are often unaware of their impact on an organization's overall cashflow. Decisions about this critical asset--cash--are often made without thoughtfully exploring the ramifications. Let's take a look at how this can occur:

Insurance company premiums. According to various studies by Sagner/Marks and other large companies, there's a precise time (25 days prior to due date) to encourage payment of premiums by the due date, and any deviation from that timing causes later payment. Yet one insurance company issued premium notices to individual and corporate policyholders <u>at times determined by access to the computer systems</u>. The decision on the premium notice date was based on factors bearing no relation to cashflow..

Hospital purchases. A not-for-profit hospital purchased supplies from various vendors, and carefully cross-checked purchase orders with receiving reports to make certain that all materials were received as ordered. The only problem was that the invoices were paid as received and verified, without regard to either the due date or the customary payment practice in the industry. This resulted in early payment by an average of five days, costing the hospital hundreds of thousands of dollars every year.

These situations are typical of a narrow focus on minor objectives that may be at odds with the major goals of an enterprise. The insurance company focussed on the convenience of the systems group, while the hospital focussed on the speedy close of a vendor transaction (sometimes called the "clean desk" syndrome). I could cite numerous other examples of this managerial focus on the wrong organizational goals; the list is as varied as the functions and types of enterprises in the world.

Principle I. *Managers often focus on minor objectives convenient to their management roles but sub-optimal to the major goals of their organizations.*

As we've seen, the various systems of defining business and performance objectives are not without flaws. It's important to remember that none of these systems are incorrect, however; in fact, they may all be correct in different situations and at different times. Customer creation and profitability may sometimes conflict with one another, but they are excellent ideas, and a business cannot long survive without them.

Fallacies in Defining Business Objectives

Several popular systems for defining business objectives have confused the task of evaluating business performance. The next few pages describe some of these systems and the flaws inherent in them.

Creating a Customer. For many years, the classic goal of the corporation was maximizing profits or return-on-equity. In 1954, Peter Drucker redefined the role to that of creating a customer. In his words, "[I]t is the customer, and he alone, who through being willing to pay for a good or for a service, converts economic resources into wealth, things into goods."[2]

In some organizations customer creation has gone beyond the traditional sales or marketing divisions and become an objective for any business unit having customer contact. Broadly defined, this can mean anyone in the enterprise, because customers need service, customers have billing questions, customers care about manufacturing quality, etc. A good example of this can be seen in the consumer marketing approach of Saturn and General Motors, with their emphasis on total immersion with the customer throughout the automobile buying and owning cycle.

No enterprise cannot survive without the creation of customers, but as we know, sales without profits cannot be made up by volume. Yet many organizations so segment the responsibilities of managers that sales become the only measure of success.

For example, a *commercial finance company* evaluated certain managers primarily by the amount of business they wrote--basically a commission plan of compensation. However, nearly every sale was won by pricing below cost. The expectation that these

losses would become profits in later years never occurred, as pricing in later years remained as aggressive as in the year the service was first sold. But commissions were huge, and the managers fought to protect that system.

In any sales function, of course, the focus is on the sale itself, not on the profit generated. Few businesses tie manufacturing, sales and administrative costs to specific sales. Even fewer have any idea if a particular sale, product or market generates appropriate threshold profits. Accounting of unit costs has historically been oriented to production and not to marketing; the job of the accountant is to tell us to the tenth of a penny the cost to manufacture a "widget". For an organization to then tie that precise production cost to all of the other costs necessary to make the sale would be highly unusual.

Personal objectives may also supersede the goals of the enterprise in situations other than sales. For example, one client of ours maintained a fleet of 1,500 automobiles for executives and managers, and paid for expensive parking space in a major U.S. city. So long as an employee "warranted" that he or she drove more than 12,000 miles per year on company business (certifying that the vehicle was not used for personal activities), the benefit remained undisturbed. No systematic attempt was made to monitor vehicle use based on trip logs or other data, and comments in our consulting report regarding this "perk" were vigorously attacked by company management.

Principle II. *Managers often focus on personal objectives that undercut their organization's overall profit objective.*

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[2]*The Practice of Management*, New York: Harper & Row, page 37.

Profitability. Earnings are an important objective in any enterprise, but for a number of reasons the concept can have little meaning to the individual manager. The manager often has very imprecise data on which to judge the profitability of his or her product, service or business line, and little input to the process of assigning costs against revenues. Allocating non-direct organizational costs to specific SBU's is particularly difficult. Furthermore, although certain costs are variable in the long-run and therefore subject to some control, nearly all costs are fixed in the short-run. For example, labor is usually considered as a variable direct cost, yet hiring, transfer and termination decisions are subject to fixed contractual and legislated restrictions.

Organizations can be sliced into any number of SBU's or profit centers, often solely on the whim of the senior executives. A bank can have an SBU for every service, every industry and every geographic market served. Or it can have an SBU for aggregations of services, industries and markets. Similarly, a manufacturing company can be separated into individual product groups or markets served, or aggregated in various ways. There is nothing magical about the SBU/profit center format. It is often touch and feel, the result of historical accident, of a consultant's report, of executive political battles over turf, or of being forced to create management jobs for workers as a form of reward.

As consultants, we've witnessed situations where the measurement of SBU profitability has gone to an extreme. Take for example a large corporation with 100 business units, each with its assignment of direct and indirect overhead. Any business units failing to meet a target return-on-equity (ROE) would be subject to elimination, on the theory that those units are a drag on enterprise results. However, the elimination of,

say, 20 units doesn't eliminate the overhead except possibly in the very long-run. Thus, the other 80 units receive a larger overhead allocation, some of them fail to meet the target ROE, and the cycle is repeated. Taken to its absurd conclusion, one SBU would remain and, of course, the enterprise would fail to meet the target return.

Realistically, the cycle stops when senior management discovers what is happening, and rethinks the ROE criterion. However, this insight can take years, causing the loss of hundreds or thousands of jobs, and significantly affecting the capability of the enterprise to offer an integrated package of goods and service to customers. For example, a large bank reduced the number of its SBU's from 175 to about half of that number over time, eliminating several SBU's which provided important but "low margin" services to corporations.

Recommendations to terminate SBU's are often made by staff or consultants not actively involved in customer contact. They fail to understand that customers buy "bundled" (rather than individual) products and services from their vendors. A business relationship involves numerous transactions that hopefully will earn an acceptable aggregate return. The vendor may lose money or break-even on a few transactions due to price competition, but this is accepted for the sake of maintaining an overall profitable relationship. In the bank situation, several of its customers were forced to find other service providers, creating considerable ill will and the eventual termination of the relationship. Years will pass before those customers will return to the bank.

Principle III. *Managers cannot manage from objectives appropriate to the enterprise but indivisible to the individual business or functional unit.*

Management-by-Objectives. MBO is a popular managerial technique requiring the manager to develop quantifiable objectives in order to measure and track job performance. For example, an MBO might be to complete all analyses within three weeks of the receipt of files, or to go on 50 sales calls, or to process 200 invoices a week. There are several problems with this approach:

- *Relevance of Objective*. Achievement of the MBO can become an end in itself, without regard to changing business conditions and organizational priorities. 50 sales calls may not be enough if they're not bringing in new business, and they may be unnecessary if several major contracts have already been made.
- *Quantity Not Quality*. The MBO measures quantity, but it doesn't measure the quality of performance. For example, a sales call can be perfunctory, 5 minutes long, without any real exchange of information, and made merely to count toward the MBO goal. Or it can be carefully planned, researched and developed, with materials, a script, "leave-behinds" (such as a brochure) and follow-up (such as a "thank-you" letter). Should these calls be counted as equivalent?
- *Validity of Objectives*. Who knows if a set of MBOs is the right set of objectives, or if some non-quantifiable objective is more important to the success of the organization? A valid objective might be to do a better job managing people through work interaction, counselling, and the advocacy of training. Yet none of these are easily measured, unless one counts the number of contacts or the number of minutes devoted to being a better manager.

Change in Objectives. During the course of a year, downsizing, reassignments, and new business initiatives may change management's allocation of resources. Many employees have had the experience of working diligently toward fulfillment of their MBO's, only to be asked to take on projects for which there is no MBO criterion. What happens at the end of the year when the MBO goal is not met but there has been progress on the new project?

There is an enormous body of literature discussing the job of the manager and how to "practice management." Unfortunately, in the real world executives most often uses a process that is simple rather than comprehensive: they count things rather than attempt to determine the quality of the manager's performance. As with downsizing, it is easier to simply count units than to do a thoughtful analysis.

Principle IV. *A quantitative system that measures the performance of managers doesn't necessarily induce behavior in the interest of either the enterprise or the manager.*

Benchmarking. A recent trend in managerial performance is benchmarking, in which similar processes are compared within and across organizations to identify "best practices." A consultant or an internal task force measures specific functions and compares those results to a designated control group. The problem with this approach is that many managers don't operate in an assembly line, standardized product kind of world, and there can be significant variations in technology and activities from one division to another

As with MBOs, benchmarks may do more harm than good as the focus shifts from the quality of a transaction to the quantity of transactions completed (or the equivalent cost). For example, once a payables disbursement is authorized, it's unlikely to be reviewed further to determine appropriateness. But consider a few of the payables reviews that should be performed:

completeness/accuracy of accounting codes

verification of signature(s) authorizing payment

coding to disbursement system

determination whether size/nature of disbursement requires special handling

diarying payment to appropriate release date

determination of disbursement mechanism/bank

These are important audits designed to safeguard the assets of an organization, and any speed-up induced by benchmarks or standards may turn the process into an unchecked assembly line. In some situations the process has turned into a work team competition, where the winning group receives recognition at the end of the month. One consulting client had a pizza party as the weekly prize for the team issuing the most checks! In such situations accuracy is too often sacrificed for speed.

The only appropriate benchmark is the comparison of equivalent things. If you do financial benchmarking, you should select specific functions, cost them, and then ask banks and vendors to bid on those services. For example, you might consider benchmarking the disbursement function. Banks/vendors offer services which accept a file of approved payments and use the preferred payment mechanism. The bank/vendor translates and formats the file and initiates the disbursement.

To develop a benchmark for payables, compare an organization's internal costs to the pricing by a bank/vendor. Then establish alternative scenarios, including:

Maintaining the Current Disbursement System (preparing and distributing payments, reconciling bank accounts, etc).

Improving Internal Processing

Analyzing computer requirements to reduce CPU time and computer support.

Re-negotiating banking costs following competitive bidding.

Reducing space requirements through computer efficiencies and floor re-design.

Outsourcing Payment Activities to a Bank or Vendor, including check writing, mailing, reconciling, ACH, EDI and Fedwire. The bank/vendor verifies the file transmission, creates the issued disbursement register, and provides reconciliation and inquiry services.

The benchmark is the price the bank/vendor bids; you must then decide whether the potential savings justify the removal of this function from your organization's direct control. There are numerous issues to be considered in such a decision, and it should be analyzed by experienced financial managers.

Principle V. *Benchmarking may oversimplify a manager's responsibilities, encourage haste in the workplace, and adversely affect product or service quality.*

Cashflow Reengineering: The Principle Objective

As we've seen, the various systems of defining business and performance objectives are not without flaws. It's important to remember that none of these systems are incorrect, however; in fact, they may all be correct in different situations and at different times. Customer creation and profitability may sometimes conflict with one another, but they are excellent ideas, and a business cannot long survive without them. Running a business day-to-day, however, is difficult without a principal objective.

If we define our principal objective as *the continual cashflow reengineering of our organization*, we give the manager and his or her management an ongoing process to guide and evaluate performance. Cash in this context is to be broadly construed, including all sources and uses of the liquidity available to the organization.

Primary liquidity, the cash first called on in a normal business environment, includes operating cashflow, short-term investments, and credit sources. Various techniques of reengineering primary liquidity sources are discussed throughout this book. Secondary liquidity, the cash subject to call in situations of distress, includes renegotiation of contracts and asset liquidation. We obviously reject the tactics of secondary liquidity for cashflow reengineering unless the survival of the organization is severely threatened.

The use of reengineering that has been proposed in recent business literature is realistic only if it defines a methodology. It is not enough to simply suggest the re-design of business processes. The manager must have procedures to follow that hopefully don't eliminate much of the workforce. The procedures described in the material which follows

focus on the analysis of cashflow activities and the evaluation of both internal and external alternatives to current processes.

Principle VI. *Managers should be evaluated on their plans for reengineering both inside and outside the boundaries of their usual functional responsibilities. This involves specific statements regarding problem areas, the methods to be used for analysis, and the functional areas and/or managers with whom cooperation and coordination will be required.*

Appendix: Methodology for Analyzing and Improving Cash Activities

The analysis and improvement of cashflow activities has become as important as the sale of product for many companies. The methodology described below is useful in documenting cashflow activities and in developing improvements to maintain organizational competitiveness and efficiency. It has been used by consultants in hundreds of studies with clients in the U.S. and worldwide.

The process of developing a payment stream matrix is discussed earlier in this chapter[3] and illustrated in Table 2-1. You should prepare a matrix for your organization, listing cash and information flows by name, dollar volume and manager. The selection of significant cash flows (usually those of $1 million or more per month) focuses the effort on those flows most important to the success of the business.

The documentation of the cashflows involves a series of tiered interviews during which managers at successively lower levels of the organization are asked to give specific

details of how each flow is handled. Flowcharting techniques are useful to depict graphically the movement of cash and related information flows for each discrete cash flow. The flow charts are supported by narratives which describe specific elements in detail, and provide account numbers, activity levels and other pertinent information. These flow charts allow you to identify illogical or inefficient cash/information flows, provide a baseline for evaluating possible changes, and facilitate communication and training among the various organizational entities which impact each cash flow. For an example of a flowchart and a narrative description of a cashflow, see Figure 2-2.

Written procedures and bank reports, along with the cash flow documentation, should be analyzed to identify opportunities for improvement. In developing ideas for improvement, it's important to utilize standard practices and trends, as well as current developments in cash management.

Study findings should be presented in a report providing a management summary, recommendations, and cash flow documentation. This may need to be a formal report that explains the methodology and findings to members of management who have not been intimately involved in the study process. The summary should include an evaluation of current cashflow practices in your organization, suggestions for any organizational changes, and a brief review of study findings.

Recommendations should include the following:

a description of each improvement idea

a summary of facts supporting the idea

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[3]At page 2-2.

the potential benefits of the change

an estimate of implementation costs and hurdles

a list of open issues which must be resolved prior to implementation. Open issues could include statutory or regulatory issues requiring clarification by legal counsel, or marketing issues related to customer reaction to proposed changes.