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Mastering Cash Flow: The Need for CFOs to Focus on Logistics

Many of the costs associated with doing business remain hidden from CEOs and senior management. Here's how to root them out, and find value through a disciplined look at logistics and supply chain management practices.

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Leveraging Logistics Practices to Create Cash Flow
If 'cash is king,' then logistics represents 'all the king's horses and all the king's men.'

Viewed another way, if our companies were a human body, then cash is the blood. Positive cash flow permits a company to operate, grow, invest and work towards organizational potential. Without proper cash flows, companies will not meet payroll, will default on payments to suppliers and operations will cease.

How does this relate to logistics? To survive these days, all organizations must focus on cash management. To focus on cash management means to understand your business from a systems point of view. That is, we need to understand in totality what the cash implications of decisions are across the functional areas of our organizations. This means we need to understand the drivers that affect cash flows inside our companies and we need to manage and control them. When we begin to manage these key cash drivers, we will quickly recognize we are in fact managing the supply chain. And to manage the supply chain, we have to be committed to sound and disciplined logistics processes.

Cash Flow Drivers
There are seven main business activities that affect cash flow. These are:

1. Accounts Payable
2. Accounts Receivable
3. Revenue Growth
4. Gross Margin
5. Sales – General and Administration (Corporate Overhead)
6. Capital Expenditure
7. Inventory

To fully understand the impact of logistics on these key cash drivers, it is important to study them individually, and then build them into a systems picture to articulate how they work together.

Accounts Payable and Cash
No business is an island, and therefore we rely on suppliers and trade partners to supply goods and services in order that we can serve our own customers. When we purchase goods and services from our supply base, we typically buy on account with a pre-determined payment agreement. When payment is due, we use cash to settle our debts. Consequently, the faster we can receive and transform purchases into our own products, the faster we will have product to sell to our customers which ultimately means cash in our till.

Note to CFO Regarding Account Payables:

1. Reduce supplier order to raw material (or service) consumption lead-time.
2. Reduce Work-in-Process inventories and focus on inbound logistics in order to optimize use of credit terms with suppliers.

Accounts Receivable and Cash
Accounts receivable are a significant driver of cash flow. In fact, "Outstanding Day's Receivables" can often be the differentiating factor of a company being fiscally viable or not. Our employees cannot pay their mortgages with receivables from our customers! This is so important, that I believe all sales people should in fact be responsible for collections as well selling product. To be sure, the order is not complete until we have received our cash.

It is no wonder the Dell Computers model is so enviable. They receive payment for goods before even ordering raw materials to build the product! Unfortunately though, most of us in the traditional world must face the reality of receivables. The ultimate goal is to receive payment as quickly as possible after we make a sale. This means we need to focus on the perfect order. In order words, we need to ensure we provide our customers with the right product, at the right place, in the right quantity and right quality.

Note to CFO regarding Accounts Receivable

1. Deliver the perfect order every time.
2. Reduce order to delivery lead times in order that payment is received as quickly as possible.

Revenue Growth and Cash

Many management gurus have argued that the only purpose of any business is to develop a customer. The logic is that without a customer there is no business model. However, we know that there are good customers and not-so-good customers. Therefore, it is important to understand that cash is generated from our good customers. A good customer can be defined as a customer who has a genuine need for our service, will be reasonably easy to do business with and will allow us to generate a competitive rate of return on our investment.

Increased revenue from good customers will result in increased cash flow. So how do we secure additional customers? The most effective way is to retain current customers and to be cost and quality leaders for new prospects. These goals will only be accomplished with a strategic focus on logistics and supply chain issues.

Note to CFO Regarding Revenue Growth

1. Retain current customers and develop new, profitable customers to generate increased cash flow.
2. Reduce inventories to become more cost competitive and increase visibility on product and process quality.

Gross Margin and Cash Flow

Gross Margin is generally defined as "Net Revenues less Cost of Goods Sold". Gross Margin is the first line of profit contribution that the firm will see from operations. It plays a significant role in cash flow. Logically, the larger the gross margin, the more gross income we will have to contribute to corporate overhead burdens and net profit. This results in cash generation (after dealing with receivable issues described earlier). To increase gross margins, we need to ensure that our cost curves do not grow linearly with our revenue curves. That is, we need to be able to generate increased revenues without a proportional increase in the cost of goods sold. This is the quintessential example of doing more with less. To reach this goal, we need to focus on Cost of Goods Sold activity drivers. And talented CFO's know that many of these drivers are logistics related.

Note to CFO regarding Gross Margin

1. Manage inbound logistics and reduce overall work-in-process supply chain and manufacturing lead times.
2. Reduce work-in-process and raw material inventories in order to reduce inventory carrying costs and therefore reduce overall cost of goods sold.

SG&A and Cash Flow

Although not all companies call it the same thing, SG&A, or Sales - General and Administrative is the most common term used for corporate overheads. Reducing the corporate overhead burden will result in increased cash to the bottom line. Many companies have outbound logistics rolled up into SG&A, and a few of these companies believe that outbound logistics is simply an evil but necessary cost of doing business. It may come as a surprise to some C – Level officers that logistics costs may exceed 12 percent of revenue. In today's business climate, where 1 percent of sales can mean the difference between viability and bankruptcy, you would think that logistics would be an area of concentration? Not to mention that logistics functions can, in fact, become a strategic area for product differentiation. There are opportunities for cost reduction with respect to logistics; however, there are also incredible opportunities to create a strategic advantage over the competition. Doing so will result in increased cash flow.

Note to CFO Regarding SG&A

1. Improve internal processes and reduce SG&A costs to ultimately increase cash flow to the bottom line.
2. Reduce customer order to delivery lead time and reduce finished goods inventory while increasing your competitive advantage.

Capital Expenditure and Cash Flow

Capital Expenditures (Capex) are the best example of how cash flow and accounting income diverge. For example, if you purchase a building for $1 million, you may decide to outlay $1 million in cash to close the purchase. However, the cost of the building will show up on the income statement as depreciation expense over the useful life of the building. The result in the first month may be $5,000 is deprecation expense, yet a full $1 million disappeared from the cash drawer. Capital Expenditures are an immense drain on cash, and possibly an area where ineffective decisions are being made. If so, these ineffective decisions may be due to ill conceived logistics strategies.

Private fleets, warehouses and advanced supply chain software are three examples of capital expenditures that require significant amounts of cash to finance the transaction. Yet, do we always know we are making the right decision? Why would we invest in a private fleet when our for-hire trucking companies have all the latest technology and years of experience in the trucking industry? Why do we continue to build warehouses when we should be focusing on eliminating the inventories that we believe we need to store in the new warehouse? When will we learn that there is no magic software pill to fix our supply chain challenges at the press of a button? Capital expenditures drain our companies of cash that can be better used in revenue generating activities. Therefore, we need to focus attention on logistics strategies that take advantage of existing infrastructure and we need to focus on effective supply chain and people processes.

Note to CFO Regarding Capital Expenditures

1. Reduce reliance on fixed assets and allow cash to be used on revenue generating activities.
2. Focus on reducing inventories as opposed to building more warehouses for inventory you don’t need.

Inventory and Cash Flow

Inventory is the most elusive of all the cash bandits. The main reason is because everything about inventory is counter intuitive. For example, consider that inventory sits on the balance sheet as a current asset. Yet as inventory sits in our warehouses, it consumes cash and it is not easily liquidated into cash (a pre-requisite to being a current asset). A case can be made that inventory is, in fact, a liability.

The second counter intuitive aspect of inventory is the self-evident law that the more inventory you have, the less likely you will have what you need when you need it. In other words, too much inventory means we are surrounded by inventory that is not needed and in fact may never be needed. To store and move this inventory is a drain of cash on our organizations.

The third, and arguably most significant counter intuitive, point about inventory is that inventory is very visible. Yet its costs and cash impact are not. Although we can walk the floors of our facilities to see inventory first hand, we cannot readily go to our financial statements and determine how much cash is being consumed by the inventory. Risk costs such as obsolescence and shrinkage drain cash. Service costs such as taxes, material handling and interest drain cash. Not to mention the implicit costs such as the opportunity costs of money tied up in inventory and the value of space being used to store the same inventory.

Note to CFO Regarding Inventory

1. Eliminate inventories and conserve cash.
2. Have the courage to gather the data required to calculate and articulate the cost of carrying inventories inside your organization.

Cash and the CFO – The Big Picture

To be competitive these days, we need to manage cash as if the life of the organization depends upon it. Logistics and supply chain activities affect the seven key cash drivers within a company. Accounts payable, accounts receivable, revenue growth, gross margin, SG&A, and capital expenditures can all be more effectively managed by focusing strategically on logistics issues. The reduction of the seventh cash flow driver, inventory, needs to become the relentless pursuit of all CFOs.

Alone, each of these seven cash drivers acts independently. Together, they form an organization’s cash-to-cash cycle. This cycle must be understood, measured and managed in order for an organization to reach its potential.

In summary, it’s important that all CFOs become involved with the logistics function and ensure that a skilled logistician holds a C-Level position within your firm and boardroom discussions.