

CASH ASLEEP IN THE BUILDING · CHAPTER ONE

Profitable on Paper, Short on Friday

A profitable quarter and a short Friday, and the ninety-five days between them.

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THE LICENCE

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Chapter One of Cash Asleep in the Building. The whole book, with every chapter, is at business.hautelumiere.life/library/cash-asleep-in-the-building (DOI https://doi.org/10.5281/zenodo.23989319).

A NOTE BEFORE YOU READ

This work is offered for education and leadership development. It is not legal, financial, accounting, investment, medical or psychological advice; take the advice of a qualified professional who knows your circumstances. Companies and events are described from the public record as the author understands it; characterisations are the author's analysis. Examples are illustrative, and no particular outcome is promised to any reader.

ABSTRACT

A profitable quarter and a short Friday, and the ninety-five days between them. It is twenty to seven on a Thursday evening, and the managing director of a firm that makes ventilation hoods for commercial kitchens is still at her desk. The office has emptied. On one screen is the management account for the quarter, and it is a good one: sales up, margin held, the best three months the firm has had since she bought it from its founder. On the other screen is the bank portal, and the overdraft is closer to its limit than it has been all year. Tomorrow is payroll. Fifty-one people will be paid, and she will make it, because a large customer paid a fortnight early when she asked, as a favour, and she has not yet worked out what that favour will cost her in the spring. Her jaw has been set since lunch.

CHAPTER ONE

Profitable on Paper, Short on Friday

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Twenty to seven, the bank portal

It is twenty to seven on a Thursday evening, and the managing director of a firm that makes ventilation hoods for commercial kitchens is still at her desk. The office has emptied. On one screen is the management account for the quarter, and it is a good one: sales up, margin held, the best three months the firm has had since she bought it from its founder. On the other screen is the bank portal, and the overdraft is closer to its limit than it has been all year. Tomorrow is payroll. Fifty-one people will be paid, and she will

make it, because a large customer paid a fortnight early when she asked, as a favour, and she has not yet worked out what that favour will cost her in the spring. Her jaw has been set since lunch.

She is a composite, drawn from the way these evenings are described in the literature on working capital and in the house's own practice, and no firm is meant. Nearly everyone who has run a business that sells to other businesses has sat in that chair at least once. The accounts say the firm is earning money. The bank says the money is somewhere else.

Ammanuel Santa Anna's book on doing business as a living system opens its chapter on money with a sentence that would have helped her at twenty to seven, because it moves the question from how much to where[1]:

> *Money in a living venture is not the point of the organism. It is the circulatory system — the medium through which vitality flows, nutrients reach every cell, and waste is carried away.*

This chapter makes one claim. When a profitable firm is short of cash, the cash is rarely missing; it is held, for days at a time, on shelves and in unpaid invoices, and every one of those days was made by an ordinary decision at a desk inside the firm. The cash conversion cycle is usually read as a ratio. It is better read as a map of who is holding the firm's money, and for how long.

A cycle with three numbers

The idea that the time cash spends inside a business can be measured is older than most of the vocabulary now used for it. In 1974 Lawrence Gitman, writing in the *Financial Review*, proposed estimating a firm's liquidity needs from the length of what he called its cash cycle: the time between paying for materials and being paid for what was made from them.[2] Six years later Verlyn Richards and Eugene Laughlin gave the measure the name it still carries. Their 1980 paper in *Financial Management*, "A Cash Conversion Cycle Approach to Liquidity Analysis", begins with an observation every finance director will recognise: working capital "occupies the major portion of a financial manager's time and attention", though the literature gave it less attention than investment and financing.[3] Their argument was that the usual liquidity ratios, which compare what a firm holds with what it owes on a single day, miss the point. What matters is how fast each kind of holding turns back into cash.

The cycle they described is three numbers and one subtraction. The first is the number of days, on average, that stock sits in the business before it is sold. The second is the number of days, on average, that customers take to pay once they have been invoiced. Add them and you have the time between the arrival of materials and the arrival of the customer's money. The third is the number of days the firm itself takes to pay its suppliers. Subtract it, and what remains is the cash conversion cycle: the number of days for which the firm, and nobody else, is financing its own trade.

Set the managing director's firm out that way, with figures chosen only to show the arithmetic. Suppose her stock, from steel coil to finished hoods waiting for collection, sits for about seventy days. Suppose her customers, most of them contractors fitting out restaurants and hospitals, pay in about sixty-five. Suppose she pays her own suppliers in about forty. Seventy and sixty-five is a hundred and thirty-five; less forty is ninety-five. For ninety-five days, on average, every pound she has spent on making a hood is a pound she does not have.

Now suppose, as a second illustration, that her firm sells about ten thousand pounds of hoods, at cost, every working day. Each day in the cycle is then about ten thousand pounds of cash held in the business. Ten days off the cycle, held steady, is roughly a hundred thousand pounds that comes back once and stays back, as long as the days do. That is the whole of the arithmetic, and it is worth doing on a napkin because it changes what the overdraft means. Her bank is not lending her money to cover losses. It is lending her money to cover ninety-five days.

The measure has known limits, and it is honest to name them before leaning on it. The three numbers are averages over very different things; a cycle of ninety-five days can hide a few customers who pay in a week and a few who pay in a season. It is usually computed from year-end balances, which a firm can flatter by the way it times its payments and its deliveries, a matter Chapter 5, on the payment run held until Monday, returns to. And it says nothing about whether the days are well spent. A distributor that keeps spare parts for emergencies may be right to hold them. The cycle tells a leader where the cash is. It does not tell her where it ought to be.

What the Belgian accounts showed

If the cycle were only an accounting identity it would not deserve a chapter. It deserves one because a body of research has asked whether firms with shorter cycles do better, and the answers, read carefully, are more interesting than the headline.

In 2003 the Belgian economist Marc Deloof published a study of 1,009 large Belgian non-financial firms over the five years from 1992 to 1996.[4] He measured each firm's days of stock, days of receivables and days of payables, and its cash conversion cycle, and set them beside its gross operating income. His abstract reports the result in two sentences. "The results suggest that managers can increase corporate profitablity by reducing the number of days accounts receivable and inventories." And then, more quietly: "Less profitable firms wait longer to pay their bills."

The second sentence is the honest grade on the first, and it is worth slowing down for. A study of this kind finds an association across many firms. It cannot, on its own, say which way the arrow points. Firms that are doing badly may hold stock they cannot sell and chase customers they cannot afford to lose, so that weak profit produces a long cycle as much as a long cycle produces weak profit. Deloof's finding on payables is a clue that some of the arrow does run that way: the firms paying slowly were the ones under

strain. In 2007 Pedro Juan García-Teruel and Pedro Martínez-Solano tested the same question on 8,872 small and medium-sized Spanish firms, from 1996 to 2002, with methods designed to deal with that reverse direction, and reported that "managers can create value by reducing their inventories and the number of days for which their accounts are outstanding."[5] Their results held, they wrote, when they allowed for the possibility that profit was driving the cycle rather than the other way round.

There is a second honest grade, and it matters for anyone tempted to push the cycle as short as it will go. In 2015 Nihat Aktas, Ettore Croci and Dimitris Petmezas studied a large sample of American firms from 1982 to 2011 and found evidence of an optimal level of working capital: firms that moved towards it, whether by reducing their investment in working capital or by increasing it, tended to improve their stock-market and operating performance.[6] A cycle can be too long, and it can be too short. A firm that strips its shelves bare to meet a target and then cannot fill an order has not released cash. It has borrowed it from next month's customers.

What this body of work supports is modest and useful. Across thousands of firms, in several countries, holding stock and receivables for fewer days tends to go with better results, and the effect survives the obvious objections. It does not support a single target, or the idea that every day removed is a gain. Santa Anna's writing on money puts the principle in a form that holds both halves at once. "Money that moves creates vitality," he writes. "Money that stagnates creates decay." The emphasis is on movement, not on scarcity. A firm with a healthy cycle is not one that holds nothing. It is one in which nothing is held without a reason.



Days are made by people

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Days are made by people

Here is where the cycle stops being a finance subject and becomes an organisational one. Every day in it was made by somebody.

Walk the managing director's ninety-five days and put a name beside each part. The stock that sits for seventy days sits because a buyer ordered steel coil in larger lots to get a better price per tonne, and because the planner builds the common hood sizes in batches of forty so that the press is not reset too often, and because the sales director, burned once by a lost order, asked for twenty finished units to be kept on hand.

Each of those decisions was sensible at the desk that made it. None of them was made by anyone who could see the overdraft.

The receivables that take sixty-five days take that long for reasons that are mostly not about the customer's willingness to pay. A large contractor's terms are sixty days because a salesperson agreed them, in the last week of a quarter, to close an order. Invoices for installation are raised only when the site manager returns a signed completion sheet, and site managers are not paid to return paperwork. A fifth of the invoices go out with a purchase-order number missing, because the order desk took the order by phone, and the customer's accounts office will not pay an invoice it cannot match. Each of these, again, was sensible somewhere. Chapter 3 is given to the invoice the customer could not pay, because the late payment is so often a fault the seller made first.

And the forty days the firm takes to pay its own suppliers are, for most firms, the one number in the cycle that someone has actually tried to manage, because stretching it is the fastest way to improve the total. It is also the one that moves cash out of somebody else's building rather than out of one's own. That distinction is the subject of Chapter 4, on ninety-day terms, and it is the reason this book counts payables differently from the other two numbers.

This is the same pattern the house's first business book found in an order that waited six days for fifty minutes of work. In Where the Flow Stops, John Little's 1961 proof that the time an item spends in a system equals the number of items in it divided by the rate at which they leave did the work.[7] It does the same work here. Stock is items waiting; receivables are invoices waiting; the days in each are the queue divided by the flow. A firm that halves the number of finished hoods on its floor, at the same rate of sale, halves the days they sit there. Nobody has to sell faster. Somebody has to decide to hold fewer.

The house's Luminous 100, its reading of the frameworks every consultancy sells, describes Michael Porter's value chain as something that should be redrawn in exactly these terms: the upgrade "transforms Porter's linear conveyor belt into a living circulatory system". The value chain asks where a firm creates value and where cost accumulates. The cash conversion cycle asks a narrower question with the same shape: where, in the circulation, the money pools.

There is a reason the pools go unseen, and it is the reason this is a book about organisations rather than a finance text. Each pool is held by a different department, and each department is measured on something else. Purchasing is measured on price, so it buys in larger lots. Production is measured on utilisation, so it builds in larger batches. Sales is measured on orders booked, so it trades terms for signatures. Credit control is measured on overdue debt, so it chases the invoices that are late and has no reason to ask why. Nobody is measured on the days. Santa Anna's canon, describing what happens to the material side of a value stream when its flow is impaired, gives the human cost a sentence that will be familiar to anyone who has worked in a firm like hers: "People spend their time expediting, fire-fighting, and working around a system that has become its own obstacle."

The managing director feels this in a particular way at twenty to seven. She is the only person in the building whose job includes all four departments, and so she is the only person who sees the cycle at all. Everyone else sees one desk's sensible decision. She sees ninety-five days, and an overdraft, and a favour she had to ask for.

The rhythm of the money

It is worth staying a moment with what the cycle does to the people inside it, because it is not only a number on a bank statement.

A long and irregular cycle makes a firm's cash arrive in lumps. A big customer pays and the account fills; payroll and the steel supplier fall due in the same week and it empties. Santa Anna's book on living ventures describes this exactly, and it is the passage the managing director would recognise first: "Continuous, not episodic. A venture that lurches between feast and famine — big deals followed by dry spells — is like a body with an irregular heartbeat. The cells never know when the next delivery of oxygen is coming." He adds what the irregularity produces: "This uncertainty creates anxiety, short-term thinking, and desperate decision-making."

That is not a figure of speech. Watch what the firm does in the weeks the account runs low. The managing director asks a customer to pay early, which spends goodwill she will need later. The finance team holds a supplier payment for a week, which the supplier notices. The buyer is told to stop ordering until the end of the month, so the next month's order is larger, which is how the lumps are made in the first place. Each move is a reasonable response to a bad week, and each one lengthens or roughens the cycle that caused the bad week. A firm in that pattern can spend years believing it has a cash problem when what it has is a rhythm problem, made by its own responses to the cash.

The canon's book on resource decisions describes the internal side of the same pattern, in which a firm short of money starts to behave as if every department must protect its own share. Its list begins with the behaviour that most lengthens a cycle: "budget hoarding (departments requesting more than they need to create buffers against anticipated cuts)". Stock is the most physical form that buffer takes. The sales director who asked for twenty finished hoods because he was once caught short is not being wasteful. He is protecting himself from a system he does not trust to warn him, and the twenty hoods are the price the firm pays for that lack of trust. Chapter 2 spends its length in the stockroom, on what each shelf is insuring against.

Santa Anna's *Ecstatic Economics* puts the principle underneath all of this in two short sentences, written about gift economies and true of a firm's balance sheet: "Wealth was not something you had. It was something you moved." The managing director's firm has plenty of wealth. Most of it, on Thursday evening, is not moving.



The cycle drawn with names

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The cycle drawn with names

What changes this is not, in the first instance, a finance project. It is a way of making the cycle visible to the people who make it.

Picture the managing director a week after that Thursday. She asks her finance manager for three numbers she already has, the days of stock, receivables and payables, and then for something she does not: the same three numbers for each of the last twelve months, so that she can see whether the cycle is steady or lurching. It lurches. Then she does something less usual. She takes one ordinary order from the previous quarter,

a set of six hoods for a hospital kitchen, and follows its money, not its paperwork, from the day the steel was paid for to the day the hospital's payment cleared.

The walk takes an afternoon. At each stage she asks the person who held the money three questions: when did it arrive with you, when did it leave, and what was it waiting for? The steel sat in the yard for nineteen days because it came in a lot of three months' supply. The hoods were built in four days and then waited eleven for the installation team. The installation took two days. The completion sheet came back from site twenty-three days later, in the site manager's van. The invoice went out the next morning, without the hospital's order number, which the order desk had never been given. The hospital's accounts office queried it on day thirty, received a corrected invoice that afternoon, and paid it on day seventy-one.

Written on a single sheet, with a name beside every gap, the walk does something the ratio never did. It shows that the longest single wait in the life of that order was not the customer paying. It was a piece of paper in a van. It shows that the hospital paid in forty-one days once it had an invoice it could match, which is well inside its terms. And it shows every department, in one picture, what it holds and for how long, without accusing anyone, because each gap has a reason and every reason is true.

She does three things with the sheet, and the order matters. She shows it first to the people whose names are on it, together, before she shows it to anyone else, so that it is read as a description of the system rather than a ranking of desks. She asks them, as a group, which gap would be cheapest to close, and they choose the completion sheet, which the installation team agrees to photograph on site and send the same day. And she puts the cycle, in days, as a single line that updates each month, on the wall where all four departments can see it, with no target written beside it yet, because a target set before the firm understands its own days will be met by moving them rather than removing them.

There are predictable ways for this to go wrong. A leader who walks only the worst order designs for the exception. A leader who sets a target for days before the walk will see the days fall at quarter-end and rise again in the first week of the next. And a leader who starts with payables, because that number moves fastest, will improve the cycle on paper while her suppliers quietly raise their prices or move her to the back of the queue. Chapter 7 carries the walk as a run sheet, with the questions in order, the arithmetic laid out, and the signs that each step is failing, and Chapter 6 places it in the order of a first ninety days.

The gain in this is real, and it can be stated precisely without inventing its size. Each day taken out of stock or receivables, and held out, returns one day's cost of sales to the firm once, and saves whatever it was costing to finance that day for as long as it stays out. It belongs to the firm's own people and process, and it can be measured against records the firm already keeps. Before anyone shares in it, it has to be measured in a way both sides would sign, against those records and agreed before the first change is made, and Chapter 5 sets out what that means for a number as easy to flatter as this one.

Drawing your own cycle

The money walk is simple enough to begin this week and particular enough to go wrong in several ways, and the book can carry the finer points the article left out.

Measure it monthly, not once a year. Most firms know their cycle only from the year-end accounts, which is the one night it is most likely to have been tidied. Ask finance for days of stock, receivables and payables at the end of each of the last twelve or twenty-four months. The line those numbers draw tells you more than any single figure: whether the cycle is steady or lurching, whether it has a season, and whether the year-end is typical or a performance.

Use the right denominator for each number. Days of stock and days of payables are usually computed against the cost of what is sold, because that is what the stock and the suppliers' invoices are worth; days of receivables against sales, because that is what customers owe. Mixing them makes a cycle look shorter or longer than it is. Whatever convention finance uses, write it down beside the line and keep it, so that next year's number is comparable with this year's.

Know the difference between days and pounds. A firm that is growing needs more cash in its cycle even if its days stay the same, because each day is worth more. The managing director's ninety-five days cost her more in a quarter of high sales than in a quiet one. Read the days to see whether behaviour is changing; read the pounds to see what the bank will feel. Confusing the two is how a growing firm decides it has a working-capital problem when it has a success.

Break the averages open. A cycle of ninety-five days is an average over every customer, product and supplier. Split each number at least once by its largest parts: the ten largest customers, the main product families, the suppliers who account for most of the spend. The average often hides a single customer on long terms, or a single product family with a warehouse of its own, and the walk is better aimed at those.

Choose an ordinary order to walk. As with the order walk in *Where the Flow Stops*, the worst case misleads. Choose an order that was typical in size and route, that finished recently enough for people to remember it, and that crossed every department the cycle touches: purchasing, production, delivery, invoicing, collection. Follow its money, not its paperwork: from the day the materials were paid for to the day the customer's payment cleared. Where the records give dates, use them; where they do not, ask, and mark the date as remembered.

Ask three questions at each stage. When did the money arrive with you, in whatever form it then took: steel, a half-made hood, a finished one, an invoice? When did it leave? What was it waiting for? The third question is the one that finds the gap, and its answers are almost always ordinary: a batch, a signature, a piece of paper in a van, a number nobody asked for.

Read the sheet with the people on it, together. The single most useful thing the walk produces is a picture every department can see at once. Show it to them before you show it to anyone senior, and read it as a de-

scription of the system. Each gap has a reason, and every reason is true. The moment the sheet is used to rank departments, the next walk will be told a tidier story.

Start with the cheapest gap in your own building. The first change should cost little and release days from stock or receivables, not from suppliers. In the walk above it was a completion sheet photographed on site. In most firms it is something of that size: a document that travels slowly, a fact nobody collects at the first contact, a batch nobody has questioned. Leave payables alone until Chapter 4 has been read.

Put the cycle where everyone who makes it can see it. One line, in days, updated monthly, on a wall that purchasing, production, sales and credit control all pass. No target beside it at first. A target set before the firm understands its own days will be met at quarter-end and missed in the week after, for the reasons Chapter 5 gives.

Expect a service firm's cycle to hide in work in progress. A firm that sells time rather than goods has a cycle too. Its stock is work done and not yet billed, and its longest gap is often between the end of a piece of work and the invoice for it. The walk is the same: follow one piece of work's money, and ask what it waited for.

Chapter 6 sets the walk at the start of a first ninety days, and Chapter 7 carries the money-walk sheet, the arithmetic of the cycle laid out so that anyone can do it, and the questions in order.

Twenty to seven, a quarter later

It is twenty to seven on a Thursday evening, the night before payroll, and the managing director is at her desk again. The management account for the quarter is on one screen. It is good, though no better than the last one. On the other screen the bank portal shows the overdraft unused.

On the wall outside her office the cycle is written in marker, in days, one number for each of the last four months: ninety-five, ninety-one, eighty-six, eighty-four. Beside it, in the installation manager's handwriting, is a note that completion sheets now reach the office in a day and a half. Nobody asked a customer to pay early this quarter.

She closes the portal before seven, and the jaw she has been setting all year, without noticing, is not set.

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