

WORKING CAPITAL INCENTIVE AND CHARGEBACK SYSTEMS

To elevate working capital to a key line priority, companies such as Borealis and Engelhard are linking working capital performance to their business units' incentive systems.

COMPANY BACKGROUND



Borealis is a leading European maker of polyethylene and polypropylene, the most common plastic resins. Borealis also produces related olefins and compounds plastic resins to meet desired characteristics, mainly for wire and cable makers. The company has production facilities in Austria, Brazil, Finland, France, Italy, Spain, Sweden, and the United States. In 2002 Borealis generated more than €3.5 billion in revenue and employed 5,085 people.

COMPANY BACKGROUND

ENGELHARD Engelhard develops, manufactures, and markets technology-based performance products and engineered materials for a wide spectrum of industrial customers. The company operates manufacturing facilities in more than 20 countries including Brazil, China, Finland, France, India, Japan, Peru, Russia, South Africa, the United Kingdom, and the United States. In 2002 Engelhard generated more than \$3.7 billion in revenue and employed 6,650 people.

Although many companies link the incentives of their business unit executives to working capital performance, Borealis takes this strategy a step further by linking each individual sales manager's incentives to working capital performance. Borealis's objective is to ensure that the real decision makers, the sales managers negotiating the contracts, consider the implications of their decisions on working capital. The finance team helps set overdues and days sales outstanding goals for the sales teams and then monitors the individual performance of each sales manager.

Working capital performance metrics impact the incentives of each sales team member and can represent up to 15 percent of a sales manager's bonus. The working capital metrics are accompanied by profitability metrics in the performance reviews to ensure that sales managers recognize the impact of trading profitability for working capital efficiency, or vice versa.

Rather than a "management by objectives" approach, Engelhard uses a simple but effective working capital chargeback system. The company subtracts a working capital use charge from business units' quarterly earnings, reducing the bonus pool for all managers in the business unit. The corporate finance group calculates the chargeback for each of Engelhard's four business divisions each quarter by multiplying the average working capital used over the quarter by the division times the firm's weighted average cost of capital. The charge reduces each unit's net income and therefore the bonus pool for all the unit's managers, from the group VP down to line managers. Since implementing this chargeback, managers across the company consider much more explicitly how their day-to-day decisions impact cash flow. Indeed, since adopting this new approach, days sales outstanding (DSO) at Engelhard has fallen by nearly 20 percent.

PAY FOR PERFORMANCE

To elevate working capital to a key line priority, Borealis implements a balanced working capital incentive system...

...and Engelhard a working capital chargeback

Borealis's Sales Manager Evaluation Form

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BOREALIS					
Review Form and Bonus Information: Mr. John Doe					
Business Unit A: 2003					
Key Performance Indicators					
	Target	Performance	Weight	Score	Total Score
1. Volume	75 kilotons	78 kilotons	15%	4	4
2. Sales Margin	€16 M	€18 M	15%	4	4
3. Working Capital			15%		4
Days Sales Outstanding	46 days	45 days		4	
Overdues	4 days	3 days		4	
⋮					
Bonus Calculation					
Total Score					3.8
Bonus (Maximum 20%)					18%

To avoid having sales managers ineffectively trade off profitability for working capital efficiency or vice versa, both metrics are included in the performance evaluation form

Overdues and days sales outstanding represent 15 percent of sales managers' bonuses

Engelhard's Working Capital Incentive

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ENGELHARD	
Business Unit: Environmental Technologies	
<i>P&L, Q1 2002</i>	
Revenue	
Cost of Goods Sold	
Gross Profit	
Selling, General, and Administrative Costs	
Operating Income	
Earnings Before Interest and Taxes	
Working Capital Charge	
Net Income	

Charge calculated as quarterly average working capital multiplied by approximate WACC

Strengths of Chargeback Approach

- Simplicity creates focus
- Standardized measure encourages teamwork
- Low resource commitment for finance

Companywide Accountability
Working capital charge lowers the bonus pool of all employees, from the group VP to line management

BOTTOM-UP EFFICIENCY

"You no longer have to go look for efficiency improvement opportunities. Now people are bringing them to you from the line because, for eight cents on every dollar that they reduce, they get a credit to that goal that everyone is measured on."

Larry Drummond
Group Controller, Environmental Technologies
Engelhard Corporation

Source: Borealis A/S; Engelhard Corporation; Working Council for Chief Financial Officers research.

WORKING COUNCIL NOTE

Working Council members have successfully improved working capital efficiency by implementing “management by objective” systems similar to that of Borealis, chargeback systems similar to that of Engelhard, and EVA-linked systems. While all three systems have advantages and disadvantages, CFOs stress the importance of well-executed implementation to make any working capital incentive system successful. The following page highlights the key advantages and disadvantages of each system and provides guidelines to ensure successful implementation.

WORKING CAPITAL INCENTIVE SYSTEMS

Advantages and Disadvantages

	Management by Objectives	Chargeback Systems	EVA-Linked Incentive Systems
Advantages	<ul style="list-style-type: none"> • Creates an instant focus on the parts of working capital that are least efficient • Produces a clear rule to guide line behavior, e.g., "No payment terms longer than 20 days" 	<ul style="list-style-type: none"> • Allows business units to weigh the benefits of a revenue focus versus improvements to working capital • Illustrates "cost of working capital efficiency" 	<ul style="list-style-type: none"> • Permits beneficial trade-offs, e.g., sales representative can evaluate the advantages of incremental revenue versus the cost of carrying an account
Disadvantages	<ul style="list-style-type: none"> • Stifles beneficial trade-offs that could be made, e.g., sales representatives might have to forgo additional revenue to achieve a 20 DSO goal • Goals can become a cap on improvement 	<ul style="list-style-type: none"> • Emphasizes accounting side of working capital over actual cash management • CFOs report that the processes often become politicized 	<ul style="list-style-type: none"> • Companies that have adopted firmwide metrics such as EVA have reported that the complexities and costs are daunting (research, adjustment of compensation and performance evaluation frameworks, new IT systems, employee training, etc.) • CFOs report that implementation can take more than a year

KEYS TO SUCCESSFUL IMPLEMENTATION

- 1. Broad Employee Participation:** Successful capital efficiency incentive programs often extend to more than 50 percent of employees.
- 2. Large Component of Compensation:** Companies which have successfully implemented performance-based incentive systems often tie more than 50 percent of their employees' total compensation to capital efficiency measures.
- 3. Gradual Implementation:** Successful implementors of performance-based incentives do not make immediate enterprise-wide shifts to the new compensation schemes; capital efficiency-based incentive plans should start from the top of the organization and gradually phase in through lower management ranks.
- 4. Elimination of Externalities:** To make sure that employees are rewarded only for things that are in their control, successful companies account for external factors, such as economic conditions and natural disasters, when measuring performance.

Source: Working Council for Chief Financial Officers research.

BOREALIS'S PERIODIC PERFORMANCE TRACKING

COMPANY BACKGROUND



Borealis is a leading European maker of polyethylene and polypropylene, the most common plastic resins. Borealis also produces related olefins and compounds plastic resins to meet desired characteristics, mainly for wire and cable makers. The company has production facilities in Austria, Brazil, Finland, France, Italy, Spain, Sweden, and the United States. In 2002 Borealis generated more than €3.5 billion in revenue and employed 5,085 people.

To ensure that operational decision makers do not focus on achieving working capital goals only when they are evaluated, Borealis creates continuous working capital performance visibility through all levels of the organization. Borealis's working capital manager sends a monthly electronic report to senior executives—including the CFO, and sales teams—with detailed receivables performance data, such as sales team's performance trends and individual sales managers' performance information. Detailed, historical data give senior managers better visibility into the performance of each sales team member over time and into the long-term working capital decisions that the line is making. This transparency encourages sales managers to implement strategies that improve working capital efficiency over the long term—not just in the short term.

To mitigate business units' resistance to this level of performance transparency, the finance team ensures that the data that it shares with all business and functional executives are accurate. Performance data come from an Infobank data warehouse system, which is updated every night with general ledger and invoice data.

FOSTERING VISIBILITY

Borealis's working capital manager sends a monthly report to finance and sales teams with detailed working capital performance data...

Report Sent to Sales and Finance Teams

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Report is sent to CFO and key corporate and business unit executives on a monthly basis, and off-schedule if immediate actions are required

From: Working Capital Manager
Sent: Monday 6 October 2003 16:08
To: CFO, Business Unit VPs, General Sales Manager, Commercial Assistance Team, Executive VPs, Shared Center Team, Accounting Team, Credit Controller
Subject: Credit Control Report—September 2003

Hi,
 Please find attached the credit report for the month of September. The PowerPoint slides contain summary comments.

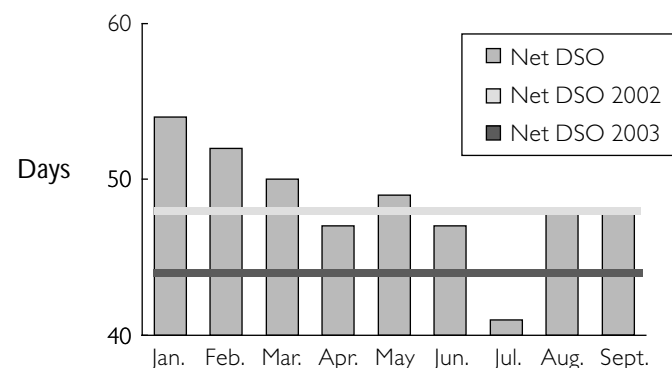
- I have also included the usual Excel file with the following data:
 1. Overdue receivable statistics per business unit
 2. DSO/DOO data per sales channel and per business unit (historical overview of DSO; DOO and net DSO)
 3. Standard payment terms to be used
 4. Largest overdue (> €50,000) customers
 5. Customers overdue more than 90 days
 6. Top 50 Borealis customer groups (measured by outstanding receivables) and their overdue statistics
 7. Total receivables by country
 8. Insolvencies
- I have included another overview of all the credit notes issued during the month of September:
 1. Commercial (pricing corrections, bonus, samples, product claims)
 2. Supply chain (quantity difference, non-product claim, distribution)
 3. Administrative (billing errors)

The attached Excel file contains 3 sheets covering these classes, including pivot tables given summary information. I have sorted within each class the credit notes by reason code and amount in euros allowing responsible managers to check whether proper authority was given.

...such as sales teams' performance trends...

Business Unit A—Net DSO Overview

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...and overdue customers by sales manager

Largest Overdue Customers

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Sales Channel	BU	Sales Manager	SAP #	Customer Name	Outstanding Receivables	Overdues
1	A	Hans Bauer	1	A	4,016,000	1,099,000
1	B	Juan Garcia	2	B	3,392,000	812,000
1	B	Juan Garcia	3	C	1,353,000	293,000
1	D	Pietro Graziano	4	D	1,422,000	273,000
1	A	Hans Bauer	5	E	1,086,000	258,000

Source: Borealis A/S; Working Council for Chief Financial Officers research.

GRANULAR PERFORMANCE INFORMATION

Borealis also fosters long-term working capital efficiency improvements by providing sales managers with key information required to develop effective working capital reduction strategies. Indeed, in addition to increasing performance visibility, the granular working capital performance information distributed monthly helps sales managers focus their working capital efforts. Information such as the performance of individual key customers, potential overdues, and credit notes helps sales managers identify the root causes of poor receivables performance, recognize trends, and develop targeted working capital strategies.

ARMING THE LINE WITH INFORMATION

Borealis's Key Customer, Overdues, and Credit Notes Information

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Largest Overdue Customers (> €50,000)					Updated 06.10.2003				
Sales Manager	SAP #	Customer Name	Outstanding Receivables €	Overdue Total	1-5 Days	6-15 Days	16-90 Days	> 90 Days	Payment Term
#1	1	A	4,016,000	1,099,000	0	1,055,000	43,000	1,000	Due 60 days e.o.m.
#2	2	B	3,392,000	812,000	0	811,000		1,000	Due 30 days e.o.m.
#3	3	C	1,353,000	293,000	0	293,000			Due 45 days e.o.m.

Benefit

- ✓ By highlighting the customers with the largest receivables problems, Borealis helps its sales managers focus their working capital management efforts

Bad Debts 2002-2003					Updated 06.10.2003	
Policy #	SAP #	Customer Name	Reason	Balance €	Country	
1	1	A	Remark: no insolvency, repayment schedule	701,437	Spain	
2	2	B	Payment schedule in place	247,050	Italy	
3	3	C	Legal case and payment schedule	651,372	Italy	

Benefit

- ✓ Granular information regarding overdue accounts helps sales managers identify pressing unresolved issues and address them

Credit Notes Overview by Reason Code							Updated 06.10.2003
Reason Code	Sales Manager	SAP #	Customer Name	Net Value €	Country	Bill Doc	
Billing Error	Alex Ormeus	1	A	52,247.96	Sweden	1	
Quality Discrepancy	Klaus Hock	2	B	3,000.00	Germany	2	
Product Claim	Carlos Perez	3	C	16,000.00	Italy	3	
Bonus	Jean-Claude Pujol	4	D	41,250.00	France	4	


Benefit

- ✓ Information regarding the drivers of credit notes enables sales teams to clearly see the invoicing problems that reduce their portfolio profitability

Source: Borealis A/S; Working Council for Chief Financial Officers research.

BOREALIS'S CUSTOMIZED WORKING CAPITAL DECISION SUPPORT

COMPANY BACKGROUND

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To help operational decision makers effectively negotiate payment terms with customers, Borealis provides its sales teams with benchmark information and country-specific receivables guidelines. Borealis gathers receivables benchmark information from multiple sources, such as credit rating agencies, and distributes it to all sales teams on a monthly basis. Aware of the terms offered by their competitors, sales teams can more effectively negotiate with customers.

Borealis sets specific guidelines to standardize the negotiations of payment terms. As regulations and market conditions dramatically vary in Europe, Borealis ensures that the guidelines it provides to its sales teams are adequate to address the particularities of each market.

GUIDING THE LINE

Borealis provides business units with benchmarking data...

Collections Benchmarking Data*

Illustrative Market Averages

Country/Area	Average Collection Period
A	45 Days
B	60 Days
C	60 Days
D	14 Days -2% or 30 Days Net
E	90 Days
F	45 Days
G	30 Days
H	60 Days
I	30 Days
J	45 Days
K	30 Days

Benefit

- ✓ Sales managers can leverage benchmark information during the contract negotiating process to improve collection terms

* Information is collected from credit rating agencies and complementary financial sources.

...and clear working capital guidelines

Country Guidelines

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Country D

Allowed payment terms

- 14 days -2% or 30 days net

Additional guidelines

- Explain rationale for all customers with term > 30 days net and plan for reverting to standard terms
- Reduce 3% discount to 2%
- Move to direct debit

Country E

Allowed payment terms

- Draft 90 days from bill of lading date

Additional guidelines

- Reduction can only be achieved if we reduce number of customers on 90-day terms
- Move to direct debit

Country H

Allowed payment terms

- Due 60 days net

Additional guidelines

- Explain rationale for all customers with cash in advance 3% and plan for reverting to standard term
- Move to direct debit

Benefit

- ✓ Clear and standardized guidelines help sales managers design contracts that meet Borealis's business objectives

Source: Borealis A/S; Working Council for Chief Financial Officers research.

PROFITABILITY PLANNING TOOL

To further enhance the negotiation process, Borealis provides its sales teams with a customer profitability planning tool that clarifies the impact of payment terms on customer profitability. Sales managers can use the tool to see how different payment terms impact the overall profitability of a customer and to improve their understanding of the interdependencies between working capital and profitability.

MAKING THE BEST DECISION

Borealis's Customer Profitability Planning Tool

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Line Item		Output (€)	Output (€/t)
Customer Name/No.	Customer ABC		
BU/Grade	Business Unit A	Product 123	
Volume (T)	Sales Volume (tonnes)	25	
Turnover (€)	Gross Price	700	17,500
	Bonus in Percentage	1%	175
	Commercial Discount in Percentage	1%	88
	Credit terms		
	Cash Discount in Percentage	2%	350
	Payment Terms (# of Days)	14	76
Est. Net Sales 1 (€)	Net Price 1	16,812	672
	Packaging	Blk Bulk tanker truck	
	Distribution	Country A	
	Delivery to:	Country B	
Est. Net Sales 2 (€)	Net Price 2	16,812	672
Variable Cost Base (€)	Monomers		
	Other raw materials		
	Other variable production costs		
	Total variable cost base		
Est. Sales Margin (€)		XX	XX
Est. Sales Margin (%)		XX%	
Other Manufacturing Costs (€)			
Other Fixed Costs (€)		XX	XX
Est. Operating Profit (€)		XX	XX
Est. Operating Profit (%)		XX%	

Tool is designed to clarify the impact of payment terms on customer profitability to make sales managers more cautious during the contract negotiating process

Source: Borealis A/S; Working Council for Chief Financial Officers research.