



A Dollar Spent is a Dollar Earned

We have all heard the phrase “you must spend money in order to make it”. Often this phrase becomes common language that is said without a keen sense of what it is implying. Is it possible that there could be meaning behind it?

As a business owner, the decisions you make on a daily basis revolve around the cash position of your entity. The past few years our current economic condition has made all of us re-evaluate *how* and *when* we spend our cash. Through this evaluation we are forced to consider the operating cycle in place and how the various components attribute to the realization of cash within our organizations.

Many of us have a sense that we are not efficiently converting our net assets to cash but we easily dismiss it by adopting key phrases such as “this is the way it has always been” or “it will not work in my company”. We become a symptom of the problem instead of a symptom of the solution. Basically it boils down to the fact that we are not comfortable with the financial tools available to us in measuring the cash conversion cycle and therefore we stop while we think we are ahead.

In general terminology a *cash conversion cycle* is the length of time it takes to produce, sell and collect money to meet your cash outflows. It is a tool from which management can determine whether the accounting policies in place are an increment or a decrement to the overall cash position of the entity. Once this determination is made, management has more leverage to make decisions that will boost its cash position in succeeding periods. For example, your current operations may necessitate short term financing to meet your obligations. What you may not realize is that by adopting new management processes such as calling on customer accounts that are past due earlier rather than later, preparing invoices with less lead time between invoice date and product ship date or services provided date and/or reducing the excess inventory levels you may shorten your operating cycle. This may result in less reliance on short term financing and therefore less interest costs.

The cash conversion cycle is the summation of several activity ratios. These ratios are described below:

Days sales outstanding (DS) =Trade accounts receivable/ (Sales/Number of days)

This ratio measures the average number of days that it takes the company to collect its receivables. The lower number of days, the faster you are collecting your receivables.

Days Cost of Sales in Inventory (DI) =Inventory/ (Cost of Sales/Number of days)

This ratio measures the length of time the company's products remain in inventory. The lower number of days, the faster you are turning your inventory into sales.

Days Cost of Sales in Payables (DP) =Trade accounts payable/ (Cost of Sales/Number of days)

This ratio measures the average number of days it takes the company to pay its obligations.

The cash conversion cycle is computed utilizing the following formula:

$$\text{Cash Conversion Cycle} = \text{DS} + \text{DI} - \text{DP}$$

An example may help you to further understand the cash conversion cycle. Both of these examples are based upon 365 days in computing the activity ratios. Example #1 represents the cash conversion cycle calculation performed based upon current operations. Example #2 assumes a \$25,000 reduction in both accounts receivable and inventory and a similar increase in accounts payable while holding sales and cost of sales consistent.

	<u>Example #1</u>	<u>Example #2</u>
Accounts receivable	\$ 150,000	\$ 125,000
Inventory	125,000	100,000
Accounts payable	50,000	75,000
Sales	1,000,000	1,000,000
Cost of sales	800,000	800,000
Days sales outstanding	55 days	46 days
Days cost of sales in inventory	57 days	46 days
Days cost of sales in payables	22 days	34 days
Cash conversion cycle	90 days	58 days

Example #1 results in an operating cycle of 90 days. This would mean that a sale made today would take 90 days to produce, sell and collect the cash to be used for future obligations.

Example #2 shows that reducing certain assets carrying amounts and extending credit terms with vendors resulted in a shortened operating cycle by 32 days. This would result in better utilization of working capital and could potentially reduce short term financing needs and interest costs. However both of these examples show that the organization is expending cash prior to cash inflows being realized and therefore a dollar spent today is a dollar earned but not in "real time".

In summary “a dollar spent is a dollar earned” appears to have some merit. However *you* can play a significant role in determining *when* and *how* that dollar is earned by understanding your operating cycle well enough to make positive changes that will result in more timely cash inflows to your organization.

Sources: *Financial Analysis CS*

www.bizfinance.about.com

www.loanfinancingguide.com

If you have additional questions about the types of services we can provide, please contact Deanna Salo or Roger Reitz. We are here to assist the FBC in any way we can.

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