Understanding the Impact of the Cash Conversion Cycle

Optimizing the Cash Conversion Cycle (CCC) affects your companies bottom-line, your cash flow and influences the amount of external funds needed to run your business. While many concentrate solely on revenues and expenses to manage cash flow, it's usually not optimizing of the CCC that often leads to a cash crunch in your business.

The CCC is equal to the time it takes to sell inventory and collect from customers less the time it takes to pay your vendors.

Effective CCC management is the result of a company selling what people want to buy, resulting in cash cycling through business quickly. If too much inventory builds up, cash is tied up in goods that cannot be sold, causing a business to slash prices, reducing profit margins. If there is difficulty in collecting payments, essentially creating a loan to the end customer, cash is not available to re-invest in the business whether in the form of investing or paying down a loan and reducing loan expenses.

Companies also benefit from slowing down the payments to vendors, as it allows them to make use of cash longer. As a business owner this is a Catch 22, slowing down your payables while hoping that others pay you quickly.

Example:
Annual sales: $5,000,000
Cost of Goods Sold (COGS): $3,000,000
Accounts Receivable (AR): $500,000
Account Payable (AP): $456,000
Inventory: $411,000

IOD = $411,000 / $3,000,000 X 365 = 50.0 days
ARO = $500,000 / $5,000,000 X 365 = 36.5 days
APO = $456,000 / $3,000,000 X 365 = 55.5 days
CCC = 50.0 + 36.5 – 55.5 = 31.0 days

In this example, cash is tied up for 31.0 days within the operation of the business. The longer cash is tied up, the more money will need to be borrowed to run the day-to-day operation. The shorter the cash is tied up, the more the business will be able to invest back into the business.

What would reducing accounts receivable and inventory by a day and extending accounts payable by a day mean to this company?

[AR – ((35.5 days/365 days) * Sales)]
+ [AP – ((54.5 days/365 days) * COGS]
+ [Inventory – ((49.0 days/365 days * COGS)]
$30,000

Therefore the company would either need to borrow less or could invest more back into the business

IOD – (Inventory / COGS X # of days in period). It measures the length of time on average between acquisition and sale of merchandise.
ARO – (Accounts Receivable / Sales X # of days in period). It measures the average number of days from the sale of goods to collection of resulting receivables.
APO – (Account Payable / COGS X # of days in period). It measures the average length of time between purchase of goods and payment for them.

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Treasury Management Tools to Help Improve the Cash Conversion Cycle

To speed up collections:

- Send bills online and encourage electronic payments. Urge clients to pay by credit card or set up electronic debits via ACH.
- Setup a Lockbox or utilize Remote Deposit so collections are immediately deposited into your account.
- Provide small discounts for payment within 15 or 30 days.
- Revise billing schedule to match customer's cash flow cycle.
- Tighten up collections. Make sure due dates are clear and when payments are late follow-up immediately via phone, email or mail.
- Switch accounts that are past due to cash on delivery.
- Turn over delinquent accounts to collection professionals, let salesmen produce.

To stretch out payments:

- Wait 30 to 45 days to pay bills if in the habit of paying on receipt.
- Negotiate terms to extend payment as long as possible. Ask for consignment terms to pay when inventory is sold.
- Pay electronically to allow last minute payment and schedule recurring payments for just in time payment.
- Mail payments on Thursday or Friday to take advantage of the 'float'.
- Pay employees twice a month as opposed to every two weeks.
- Arrange smart leasing terms that match the seasonality of your business.
- Use credit cards for travel and expenses to stretch out payments and to take advantage of rewards programs and rebates.

ACB offers a full array of Treasury Management solutions to successfully attain strategies above including:

- Treasury Management via the Internet to initiate ACH and Wire Transfer transactions
- Lockbox Processing
- Remote Deposit
- Credit Card Processing
- Online Bill Pay
- Business Credit Card programs

Let us analyze your Cash Conversion Cycle and make recommendations to optimize your business' cash flow.

Contact your American Chartered Banker for additional details.