

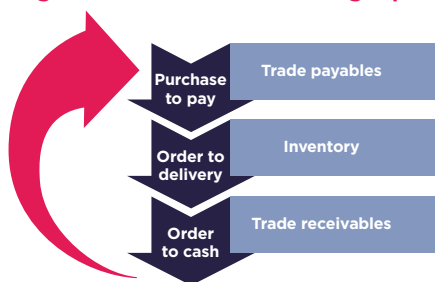
THE CASH CONVERSION CYCLE

Efficient management of working capital is crucial to business success.
Sarah Boyce explains how it's done

While large, one-off investments can be funded through raising new finance from the debt and equity markets, it is the funds from ongoing operations that service debt, pay dividends and pay for labour, goods and services.

In simplest terms, such funds are generated by the receipt of income from the sale of goods and services. More specifically, a supplier (creditor) provides stock, the stock is then sold on credit, creating a debtor. In due course, the debtor pays, thus providing the company with cash resources that are then used to pay the creditor and the surplus cash is retained within the business. This is the working capital cycle.

Figure 1: Elements of the working capital cycle

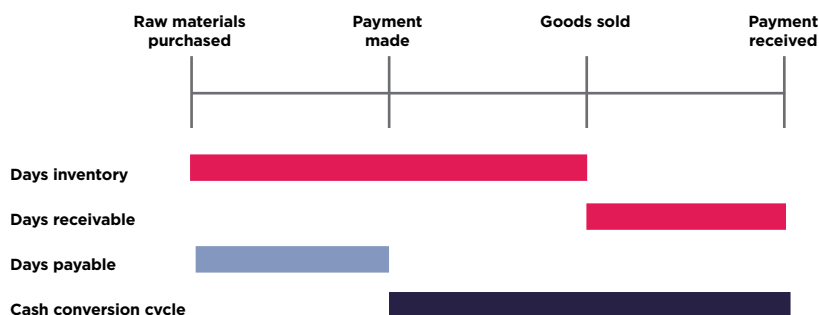


The three key components of working capital are trade receivables, trade payables and inventories, and their control (ie working capital management) is critical to the liquidity of the company. So, although this may not be viewed as an exciting area of finance, it is crucial to the long-term success of any organisation.

The cash conversion cycle (CCC) – is a measure of how long cash is tied up in working capital. It quantifies the number of days it takes a company to convert cash outflows into cash inflows and, therefore, the number of days of funding required to pay current obligations and stay in business.

The operating cycle – which consists of money tied up in receivables and inventory (the red bars on the chart, above right) – is offset by trade payables, which are a source of liquidity. (While they represent a future use of funds since

Figure 2: The cash conversion cycle



they will need to be paid, the company still has access to the funds until payment is made.)

Together, this results in the CCC. The formula for calculating the CCC is as follows:

$$CCC \text{ (days)} = \text{days inventory outstanding} + \text{days receivable outstanding} - \text{days payable outstanding}$$

Where:

◆ **Days inventory outstanding** = (average inventory/cost of goods sold) x 365, ie the average number of days it takes for inventory to be sold. A lower number is generally desirable while still ensuring that sales demand can be met.

◆ **Days receivable outstanding** = (average accounts receivable/sales) x 365, ie the average number of days it takes for a company to collect payment. A lower number is desirable while ensuring that the organisation does not put itself at a competitive disadvantage to other potential suppliers through overly aggressive settlement terms.

◆ **Days payable outstanding** = (average accounts payable/cost of goods sold) x 365, ie the average number of days it takes a company to pay its creditors. A higher number is desirable, but a balance needs to be maintained between delaying payment and retaining the goodwill of suppliers or taking advantage of any early payment terms.

The shorter the CCC, the healthier a company generally is. Businesses shorten the CCC by condensing the operating

cycle (by reducing inventory or collecting cash more quickly) and/or by delaying payments to suppliers.

The CCC can even be negative – for instance, if the company has a strong market position and can dictate terms to customers and/or suppliers (for example, if it can postpone its payments).

Benchmarking the CCC against a peer group rather than companies in general is often more valuable since, for example, some industries have no inventory (such as transport companies), some have no receivables (for example, supermarkets) and others have no creditors, usually because no one trusts their credit.

Conclusion

Good management of the CCC supports cash flow forecasting and enables better long-term funding and investment decisions, a reduced risk of bad debts, improved liquidity and hence stronger balance sheet ratios (and from this, increased creditworthiness).

There are practical, operational and commercial limitations on how low working capital levels can fall without adversely affecting operations and relationships, however. As a result, the management of working capital is essentially a compromise between levels high enough for smooth commercial operation and levels low enough to be financially efficient. ♦

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