Cash Conversion Cycle

by Sophia

WHAT'S COVERED

In this lesson, you will learn about a company's cash conversion cycle. Specifically, this lesson will cover:

1. Cash Conversion Cycle

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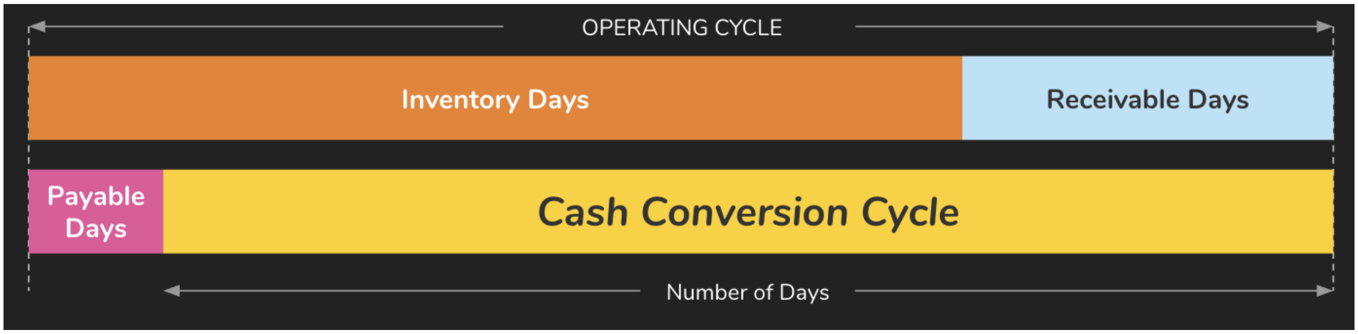
In the last lesson, the components that need to be managed in working capital management were discussed. In this lesson, we will look at the relationship between them in the cash conversion cycle.

Recall the importance of sufficient cash on hand and how that relates to accounts receivable, inventory, and short-term borrowing. The current impact of all of these can be measured using a business's cash conversion cycle. The **cash conversion cycle** is the length of time it takes a company to convert cash spent into cash received.

STEP BY STEP

- *Inventory Days:* The cash conversion cycle begins when inventory is received. During the inventory cycle, goods move from raw materials to work in progress to finished goods that are eventually sold.
- *Receivable Days:* At the time of sale, the business may still not have received its cash because the sale is on credit. Therefore, we add on to the cycle the number of days it takes to receive payment. Together, the inventory days plus the receivable days are called the operating cycle.
- *Payable Days:* If the business can take advantage of trade credit, it will not expend cash when it gets inventory but rather when they pay their supplier later. This period of time is a number of payable days.
- *Cash Conversion Cycle:* When we subtract the payable days from the operating cycle we have the cash conversion cycle. This is the number of days from the time a business pays its creditors to the day that a customer pays their bill.



The Cash Conversion Cycle can then be expressed in the following formula:

FORMULA TO KNOW

Cash Conversion Cycle

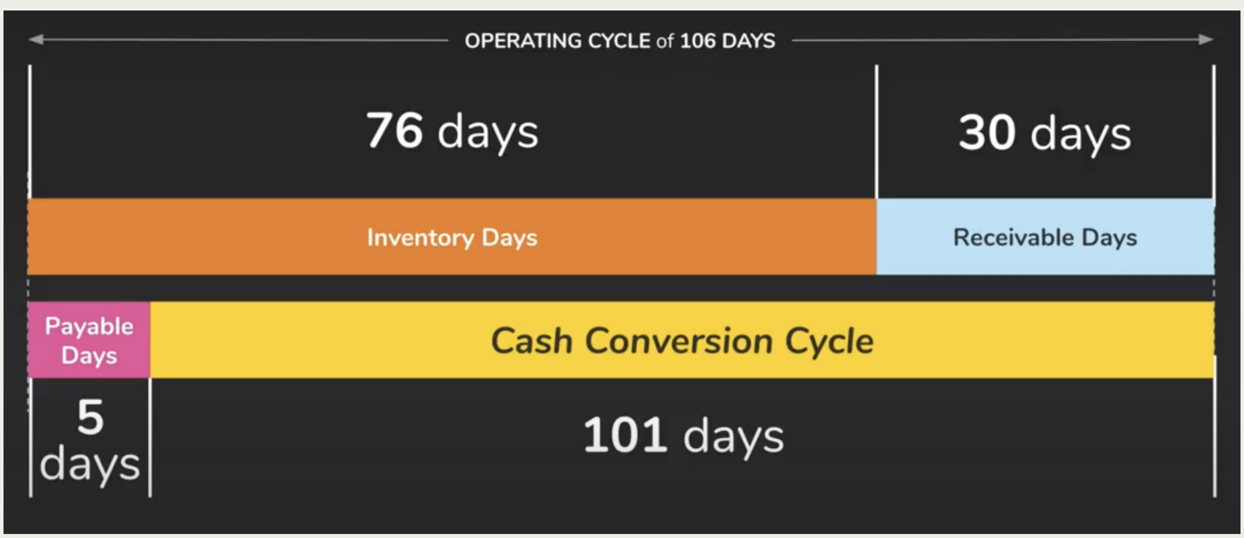
$$CCC = \text{Inventory Conversion Period} + \text{Receivables Conversion Period} - \text{Payable Conversion Period}$$

BIG IDEA

The number of days it takes a company to convert cash spent into cash received is equal to the inventory conversion period plus the receivables conversion period minus the payables conversion period.

IN CONTEXT

Suppose a company keeps 76 days of sales in inventory, which are spread through the various phases of raw materials, work in process, and finished goods. When they look at their accounts receivable, they find that their receivables are paid, on average, in 30 days. They look at their accounts payable, the money they own their suppliers, and find that they pay in five days.



The company's cash conversion cycle is 76 days of inventory plus 30 days of accounts receivable outstanding minus 5 days accounts payable sales. This makes the cash conversion cycle equal to 101 days.

Once a company determines its cash conversion cycle, it can do some analysis to make improvements such as carrying less inventory or not paying their accounts payable as quickly as they do. The credit policy and amount in accounts receivables are always open to inspection; some customers may pay with cash and others may pay late.

TERM TO KNOW

Cash Conversion Cycle
The length of time it takes a company to convert cash spent into cash received.

SUMMARY

In this lesson, you learned that the term **cash conversion cycle** refers to the time span between a firm's dispersing cash and collecting cash. It involves close management of inventory procurement, accounts receivable management and credit policy, and how long the company takes to pay its suppliers. The cash conversion cycle can be estimated as the days sales in inventory plus the days sales in receivables minus the days sales in accounts payable.

Best of luck in your learning!

TERMS TO KNOW

Cash Conversion Cycle
The length of time it takes a company to convert cash spent into cash received.

FORMULAS TO KNOW

Cash Conversion Cycle
$$CCC = \text{Inventory Conversion Period} + \text{Receivables Conversion Period} - \text{Payable Conversion Period}$$