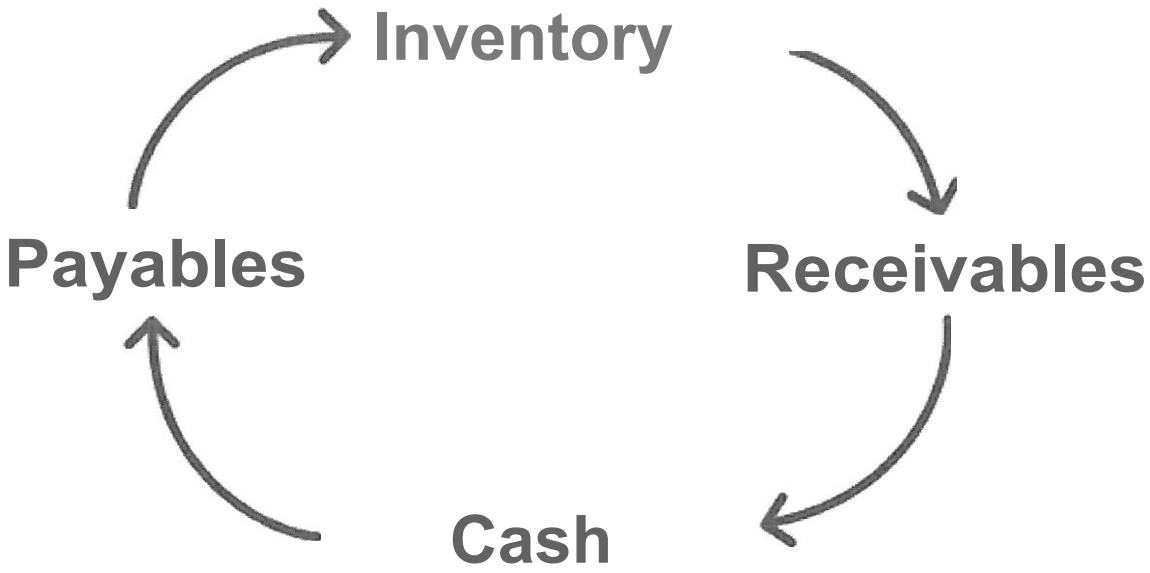
The Cash Conversion Cycle?

The Cash Conversion Cycle (CCC) is a metric that shows the amount of time it takes a company to convert its investments in inventory to cash. The cash conversion cycle formula measures the amount of time, in days, it takes for a company to turn its resource inputs into cash.



Cash Conversion Cycle Formula

The cash conversion cycle formula is as follows:

Cash Conversion Cycle= D10 + D50 - DPO

Where:

- DIO stands for Days Inventory Outstanding
- DSO stands for Days Sales Outstanding
- DPO stands for Days Payable Outstanding

What is Days Inventory Outstanding (D10)

Days Inventory Outstanding (DIO) is the number of days, on average, it takes a company to turn its inventory into sales. Essentially, DIO is the average number of days that a company holds its inventory before selling it. The formula for days inventory outstanding is as follows:

$$DIO = \frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} \times 365$$

For example, Company A reported a €1,000 beginning inventory and €3,000 ending inventory for the financial year ended 2018 with €40,000 cost of goods sold.

The D1O for Company A would be:

$$DIO = \frac{(€1{,}000 + €3{,}000) / 2}{€40{,}000} \times 365 = 18.25$$

Therefore, it takes this company approximately 18 days to turn its inventory into sales.

What is Days Sales Outstanding (DSO)?

Days Sales Outstanding (DSO) is the number of days, on average, it takes a company to collect its receivables. Therefore, DSO measures the average number of days for a company to collect payment after a sale. The formula for days sales outstanding is as follows:

$$DSO = \frac{\text{Average Accounts Receivable}}{\text{Total Credit Sales}} \times 365$$

For example, Company A reported a €4,000 beginning accounts receivable and €6,000 ending accounts receivable for the financial year ended 2018 with credit sales of €120,000.

The DSO for Company A would be:

$$DSO = \frac{(€4,000 + €6,000) / 2}{€120,000} \times 365 = 15.2$$

Therefore, it takes this company approximately 15 days to collect a typical invoice.

What is Days Payable Outstanding (DPO)?

Days Payable Outstanding (DPO) is the number of days, on average, it takes a company to pay back its payables. Therefore, DPO measures the average number of days for a company to pay its invoices from trade creditors, i.e., suppliers. The formula for days payable outstanding is as follows:

$$DPO = \frac{\text{Average Accounts Payable}}{\text{Cost of Goods Sold}} \times 365$$

For example, Company A posted a €1,000 beginning accounts payable and €2,000 ending accounts payable for the financial year ended 2018 with €40,000 cost of goods sold .

The DSO for Company A would be:

$$DPO = \frac{(€1,000 + €2,000) / 2}{€40,000} \times 365 = 13.69$$

Therefore, it takes this company approximately 13 days to pay for its invoices.

Putting it together: Cash Conversion Cycle

Recall that the Cash Conversion Cycle Formula= DI0 + DSO - DPO. How do we interpret it?

We can break the cash cycle into three distinct parts: (1) D10, (2) DSO, and (3) DPO. The first part, using days inventory outstanding measures how long it will take the company to sell its inventory. The second part, using days sales outstanding, measures the amount of time it takes to collect cash from these sales.

The last part, using days payable outstanding, measures the amount of time it takes for the company to pay off its suppliers. Therefore, the cash conversion cycle is a cycle where the company purchases inventory, sells the inventory on credit, and collects the accounts receivable and turn it into cash.

Using the D10, DSO, and DPO for Company A above, we find that our cash conversion cycle, for Company A, is:

CCC= 18.25 + 15.20 - 13.69 = 19.76

Therefore, it takes Company A approximately 20 days to turn its initial cash investment in inventory back into cash.

Interpreting the Cash Conversion Cycle

The cash conversion cycle formula is aimed at assessing how efficiently a company is managing its working capital. As with other cash flow calculations, the shorter the cash conversion cycle, the better the company is at selling inventories and recovering cash from these sales while paying suppliers.

The cash conversion cycle should be compared to companies operating in the same industry and conducted on a trend. For example, measuring a company's cash conversion cycle to its cash conversion cycles in the previous years can help with gauging whether its working capital management is deteriorating or improving. In addition, comparing the cash conversion cycle of a company to its competitors can help with determining whether the company's cash conversion cycle is "normal" compared to industry competitors.

The lower the cash conversion cycle the better a company is managing its working capital. This is a key metric to measure the financial health of a business. Some businesses adapt their business model to turn their cash conversion cycle negative. This gives these companies access to a source of very cheap funding, instead of financing their working capital with debt or shareholder equity, working capital is providing funds to the business. This can be a significant source of competitive advantage if a business can finance itself at a lower cost than its competitors, it can pass on a price reduction to its customers.

If you are not getting paid on time now there is no need to wonder why!