Source: *The Sunday Times*, pB12
Date: 22 April 2018

FinancialQuotient

What is cash conversion cycle?

Ted Teo

WHAT DOES IT MEAN?

A company's cash conversion cycle refers to the time period starting with the company's cash being expended for the production of goods until cash is received from customers in payment for those goods.

It can be estimated by totalling the days sales outstanding and the days sales in inventory, and subtracting the days payable outstanding.

WHY IS IT IMPORTANT?

"Cash is king" is an expression often used to emphasise the importance of the availability of cash to a company. It is cash that a company pays salaries and repays loans with, which keeps it operating as a business, not its reported account receivable or sales revenue.

The business activities covered in the cash conversion cycle include the purchase of raw materials, storage, the production process, payment of salaries and the sales of goods. It is important to know the cash conversion cycle because it is the time period for which cash is tied up in a business.

A decrease over time in this cycle indicates that cash is freed up more quickly with each sale cycle.

It may be a result of tighter management of account receivable, a more efficient control of the inventory-to-sales cycle, or better account payable terms with suppliers.

On the contrary, an increase in this cycle over time warrants the company's attention on its cash conversion.

Cash conversion cycles tend to be much shorter for companies in the service business than those in the goods business. By examining how this cycle changes over time, one can detect subtle changes in the company's cash flow position.

IF YOU WANT TO USE THE TERM, JUST SAY:

"By successfully adopting the just-in-time manufacturing system, this furniture firm is able to compress its cash conversion cycle drastically by keeping inventory to its minimum."

• The writer is adjunct senior lecturer, department of finance, National University of Singapore Business School.