

Cash Conversion Cycle

A crucial tool in managing a firm's working capital is the Cash Conversion Cycle (CCC). It measures - in days - the time required till cash bound in a firm's production process and inventory flows back via payments made by its customers. Therefore, the CCC also determines how much minimum cash a firm requires to safely maintain production and operations.

The extreme example of a seasonal industry, such as that of manufacturing skis, underlines the importance of the CCC concept: Skis are foremost bought prior to the start of the winter season, before Christmas, hence around November, December. Therefore, this is also the time when a ski manufacturer collects cash from its customers. – Meanwhile, the rest of the year is characterized by cash outflows: New models for the next season have to be developed, designed and made ready for their presentation at trade fairs, most of them taking place in early spring. Over spring and summer, production is in full swing, whereby raw material, personnel, rent, electricity have to be paid on time. Finally, in late fall skis are shipped to major distributors and – again – sold. – Therefore, in any seasonal industry, such as ski manufacturing, it is absolutely essential to closely observe and optimally manage the CCC: In essence, one would have to pre-finance more or less a full year of production before cash flows back to

the firm. (In regards to skis, the consequences of a season with no snow at all, may be left to one's imagination).

Therefore, understanding the CCC helps a firm to estimate minimum liquidity and funding requirements so that payment requests from suppliers, workers and staff, landlords or utility providers can be timely met.

The CCC is calculated in subtracting days payable from the sum of days receivable, inventory turnover and the cash turnover. Latter is usually assumed to be driven by the revenues per day, till the cash pool is – metaphorically – again fully replenished – or turned over.

To determine a firm's required minimum liquidity (by cash or access to funding) one may multiply the days of the CCC with daily cost of goods sold and daily overhead cost. This amount would ensure maintaining a firm's operation till cash bound in working capital flows back again.

Therefore, the CCC concept plays an important role within a firm's liquidity planning. If one added to the CCC-based liquidity requirements expected (net) cash outflows (e.g. anticipated interest expenses, capital expenditures) as well as some cushion on top of this, then a firm's total estimated liquidity requirements should be fairly accurate.

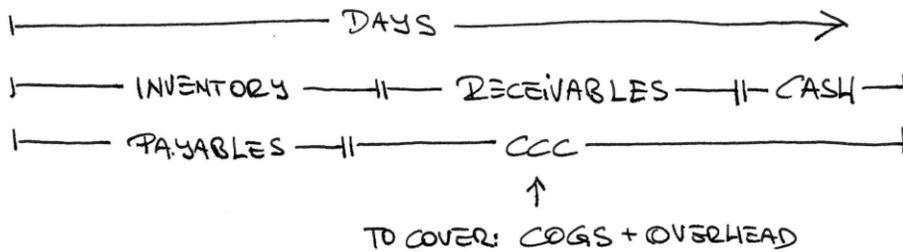
BALANCE SHEET

CASH	PAYABLES
RECEIVABLES	
INVENTORY	

INCOME STATEMENT

REVENUES
- COST (PERSONNEL, MATERIAL)
= EBITDA

$$\begin{aligned}
 & \text{DAYS CASH TURNOVER} && \text{CASH} / \text{DAILY REVENUES} \\
 + & \text{DAYS RECEIVABLES} && \text{REC} / \text{DAILY REVENUES} \\
 + & \text{DAYS INVENTORY TURNOVER} && \text{INV} / \text{DAILY COST} \\
 - & \text{DAYS PAYABLES} && \text{PAYABLES} / \text{DAILY COST} \\
 \hline
 = & \text{CASH CONVERSION CYCLE (DAYS)}
 \end{aligned}$$



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