WORKING CAPITAL REVIEW

The Cash Conversion Cycle

In order to manage working capital efficiently, a firm has to be aware of how long it takes them, on average, to convert their goods and services into cash. This length of time is formally known as *the cash conversion cycle.*

The cash conversion cycle is made up of 3 separate cycles:

1. *The production cycle*: i.e. the time it takes to build and sell the product
2. *The collection cycle*: i.e. the time it takes to collect from customers (i.e. collecting accounts receivable) and
3. *The payment cycle*: i.e. the time it takes to pay for supplies and labor, i.e. paying accounts payable).

The production cycle and the collection cycle together make up the *operating cycle*, so the cash conversion cycle can also be calculated as follows:

Cash conversion cycle = Operating cycle – Payment cycle.

- The production cycle begins when a customer places an order and ends when the product is shipped out.
- The collection cycle begins when the order is filled and ends when payment is received.
- The payment cycle begins when labor is hired or raw materials are received to start production and ends when the firm pays for purchases, raw materials and other production costs.
- Since firms typically have to pay for production costs before they receive payment from their customers, a longer cash conversion cycle would tie up their finances and vice-versa.
- It, therefore, makes sense to keep track of these various cycles and try to shorten the cash conversion cycle so as to free up much needed funds.

Putting it all together: The Cash Conversion Cycle:

If a firm can shorten its production cycle or its collection cycle, or both, while keeping its payment cycle constant or lengthened, it can shorten the number of days that it would typically have to finance its operations for, thereby reducing its financing costs and increasing its profits. Thus, shortening the cash conversion cycle essentially requires the efficient management of receivables (credit policy), inventory, and payables.

Managing Accounts Receivable and Setting Credit Policy

- A firm's credit policy, if too lax can lead to increased defaults, and if too strict, can lead to lost sales.
- Thus, firms have to establish well-balanced credit and collection policies to efficiently manage working capital.

Credit: A two-sided coin:

- One firm's accounts receivable is another firm's accounts payable.
- If a firms shortens it collection cycle by tightening its credit policy, its suppliers could do the same, which would negate the effectiveness of the strategy.
- It is imperative for firms to establish good credit policies regarding screening, payment terms, and collecting of over-due bills.

Setting Payment Policy:

An important part of credit policy is to determine how many days of free credit to grant customers and whether or not to offer discounts for paying early, and if so, how much of a discount.

Discounts, if high enough, tend to be mutually beneficial, since the seller frees up cash and the buyer pays less.

The Float

"Float," which refers to the time it takes for a check to clear, is of two types.

Disbursement float is the time lag between when a buyer writes a check to when the money leaves his or her account.

Collection float is the time lag between when a seller deposits the check to when the funds are received in the account.

Speeding up the Collection (Shortening the Lag Time): Firms attempt to speed up collections in a variety of ways including:

- **Lock boxes**, which are post office boxes set up at convenient locations to allow for quick pick up and deposit of checks by the firm's bank.
- **Electronic fund transfers (EFT)** which occur directly from the buyers account. For example by accepting debit cards.

Questions

1. **Explain the three components of the cash conversion cycle.**
   The three components of the cash conversion cycle are the production cycle, the collection cycle (also known as the accounts receivable cycle) and the payment cycle (also known as the accounts payable cycle). The production cycle is the time it takes to produce and sell a product or service. The collection cycle is the time it takes from the sale of the product or service until cash is collected from the sale. The payment cycle is the time between the order of supplies or raw materials and the payment to suppliers for these items.

2. **Why should a company attempt to speed up its receivables and slow down its payables?**
   Speeding up receivables or slowing down payments reduces the cash conversion cycle. The cash conversion cycle reflects the time a company must fund its operations. A shorter cash conversion cycle means less funding necessary for operations.

3. **How can a company "encourage" its slow-paying customers to pay their outstanding bills?**
   One way to encourage slow paying customers is to offer discounts for quicker payments.

4. **What is credit screening? When would it be appropriate for a company to use credit screening? When would it be appropriate for a company to not use credit screening?**
   A credit screen is a process to identify potential bad loans (non paying credit customers). It is appropriate to use a credit screen when the cost of the screen does not outweigh the benefits of the screen. That is, as long as the potential bad customers are eliminated from credit sales and good customers are not eliminated from credit sales, it is appropriate to use a cost effective credit screen.
5. **Why is it often a good practice to simply write off a bad debt rather than pursue payment from a credit customer?**
   It is expensive to try and collect all bad debts and when the cost of recovering the sales dollars is greater than the sales dollars it is better to simply write-off the bad debt and take the tax credit.

6. **Should a company take all discounts offered by its suppliers? What criteria should be used when accepting or rejecting a discount on an invoice?**
   Companies should only take those discounts where the implied interest rate is greater than what they can earn by keeping their funds until the payment date for the full amount of the invoice. The criterion is the average hurdle rate or cost of capital for the company (its borrowing rate from other lenders).

7. **What is the float? Why does it take time between when you write a check and when the funds come out of the account?**
   The float is the time between when a check is written and when the funds leave the account. The time lapse is due to the time the check is held and processed by the receiver of the check, the time the check travels from the receiver's bank to the issuer's bank, and any processing time at the issuer's bank. The time between banks is now less due to Check 21, the legislation that permits electronic transfer of funds between banks for checks.
8. **When might it be detrimental to a company to have too many items in inventory? When might it be detrimental to have too few?**
   Too many inventory items may be costly for a company due to the cost of storing and maintaining inventories. Too few inventories may result in lost sales when a company is out of stock or production stoppages when replacement parts are not in stock.
9. **What is an economic order quantity? What cost does it attempt to minimize?**
   An economic order quantity is the optimal order size that minimizes the total inventory costs of an item.

10. **Why might a company have extra inventory on hand above the amount suggested by the economic order quantity?**
    Extra inventory or safety stock is held by a company because orders can and do get delayed in shipping and the safety stock helps reduce the potential out of stock problems that result in down production time or lost sales.