

Working With Your Banker

Cash Conversion Cycle

Income Statement	
	March
Sales	90,000
Costs	<u>75,000</u>
Profit	<u>15,000</u>

Let's look at a simple example. Here's an income statement. At first glance, you might expect to have an additional \$15,000 in hand at the end of March. However, the cash inflow from sales and the outflow of costs don't necessarily coincide with the recording of those sales.

Here's a simple cash flow forecast relating to the sales recorded in March. As you can see, most of the cash wasn't received until 60 days later, in May.

Cash Flow Forecast - relating to March sales only				
	March	April	May	Total
Receipts from Sales	15,000	18,000	57,000	90,000
Payments to vendors, etc.	<u>30,000</u>	<u>25,000</u>	<u>20,000</u>	<u>75,000</u>
Net cash flow	<u>-15,000</u>	<u>-7,000</u>	<u>37,000</u>	<u>15,000</u>
Cumulative net cash flow	-15,000	-22,000	15,000	<u>15,000</u>

However, most vendors were paid for the materials and supplies necessary to deliver those sales in March and April. This resulted in a temporary shortfall of cash in March and April.

Suppose this was a start-up business, or an existing business starting to work with new vendors. In these circumstances, vendors may require advance payments. Look at the effect that advance payments have on the cash forecast. In this example, the cash shortfall lasts three months!

Cash Flow Forecast - relating to March sales only					
	February	March	April	May	Total
Receipts from Sales	0	15,000	18,000	57,000	90,000
Payments to vendors, etc.	<u>15,000</u>	<u>30,000</u>	<u>25,000</u>	<u>5,000</u>	<u>75,000</u>
Net cash flow	<u>-15,000</u>	<u>-15,000</u>	<u>-7,000</u>	<u>52,000</u>	<u>15,000</u>
Cumulative net cash flow	-15,000	-30,000	-37,000	15,000	<u>15,000</u>

This example illustrates the cash conversion cycle – the number of days it takes a company to purchase raw materials, convert them to a finished product, sell that product to a customer, and receive payment from a customer for that product. It's unwieldy to actually match your cash collections with the funds expended to purchase the related materials, so we rely on several ratios to help us with the calculations.