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Managing Cash 101 and the “lifeline” of your Business

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Calculating and Managing Your Cash Conversion Cycle

One of the best ways to boost cash flow is to improve management of your cash conversion cycle. This is the movement of cash through your business as products are manufactured and sold, payment is collected, and cash is converted back into raw materials and inventory once again.

It's important to calculate your company's cash conversion cycle to determine if you will have enough liquid capital to keep operations running. Doing so is a mathematical exercise that can easily be computed. We handle and work with all industries, however here is an example of a typical manufacturing company's cash conversion cycle usually looks something like this:

1. Cash is paid out for equipment, raw materials, salaries, overhead, etc.
2. These outlays are used to manufacture products.
3. The products may then be stored in a warehouse until sold to customers.
4. After products are sold, the business issues an invoice to customers, creating accounts receivable.
5. Accounts receivable are collected from customers, which brings cash back in again.

The total number of days from the beginning of step number one until the end of step number five represents the length of your cash conversion cycle. The challenge is to reduce this number of days and the resulting cash flow lag. Or in other words, the goal is to convert the dollars used in the inputs (raw materials, inventory, wages, rent, utilities, etc.) required to manufacture and distribute products into collected receivables more quickly.

How To Do It

To the extent that you can effectively manage your cash conversion cycle, you can reduce your need for external borrowing or raising more equity capital. Here are four steps for accomplishing this:

Collect your accounts receivable faster. Depending on your industry, you probably have to offer payment terms of some type to your customers (e.g., net 30 days). Negotiate with customers to try to shorten these terms, if possible. One strategy is to offer a discount for paying early. For example, with a “2-10, net 30” discount, the customer would receive a 2 percent discount on the invoice if it's paid in 10 days instead

of 30. Also get serious about collecting past-due receivables, since the chances of collecting are reduced drastically over time.

1. Disburse your accounts payable more slowly. You should always pay invoices according to the terms you've negotiated with your suppliers, but you'll receive no benefit from paying early. Work closely with your accounting department to set up a payables management system in which all invoices are paid as close to the due dates as possible.

2. Manage your inventory more efficiently. By implementing just-in-time (or JIT) inventory management, your raw materials will be delivered as they're needed, not weeks (or even months) early. Also, don't hesitate to cut your losses on slow-moving inventory items, even if this means selling them at a big discount. Doing so will free up valuable cash that can help carry you through the cash conversion cycle.

3. Utilize treasury management services from your bank. Talk to your bank about treasury management products and services that can help accelerate the collection and posting of your accounts receivable. These may include wholesale lockbox, remote deposit capture (RDC), and electronic payments via the Automated Clearing House (ACH).

With wholesale lockbox, check float is reduced considerably: Your customers send payments to a special post office box where the bank picks them up and deposits them immediately. RDC, meanwhile, lets you deposit checks remotely from the convenience of your office without even having to go to the bank. And the ACH eliminates check float completely by sending payments electronically, instead of by check.

Conclusion

Regardless of how strong your company's sales and revenue are, it takes cash to keep your business going. One of the best ways to boost cash flow is to improve management of your cash conversion cycle. It's important to calculate your cash conversion cycle to determine if you will have enough liquid capital to keep operations running, and to manage your cycle in order to reduce your need for external borrowing or raising more equity capital. An outsourced CFO services provider can help you make this calculation and take steps to reduce your cash conversion cycle and cash flow lag.

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