Capital Corner
Use Cash Flow Management for a More Profitable Business

By Jim Morphey, Vice President of Corporate Development, GE Capital, Commercial Distribution Finance

Cash Flow shows the amount and speed of funds flowing into and out of your business. Understanding and managing cash flow can help improve Return on Investment (ROI) if it is managed properly. While many business owners look at Sales or Gross Margin to measure the health of their business, Cash Flow management can be an even more valuable tool for profitable growth and success!

Your challenge is to shorten the cash flow cycle as much as possible, while extending your accounts payable as much as is allowed under your interest-free financing terms. A shorter cash conversion cycle also improves your ROI. Let's face it…your business is your "401K' for the future. We all want the highest return possible on our investments!

A Simple Plan

We all know that to have a successful business, you have to manage it well. Luckily, we have a few simple measures to get you on the road to understanding better cash flow management.

Let's take a look at your Cash Cycle. There are two standard measures:

Days Inventory Outstanding

$$DIO = \left(\frac{\text{ENDING INVENTORY}}{\text{TOTAL COST OF GOODS SOLD}} \right) X \text{ DAYS}$$

Days Sales Outstanding

$$DSO = \left(\frac{\text{ENDING ACCOUNTS RECEIVABLE}}{\text{TOTAL SALES}} \right) X \text{ DAYS}$$

Many business owners use 90, 180 or 360 days as the time period. Your CSHPI representative can help you determine the appropriate number of days to use for your business. The formula is always the same, just change the number of days in your formula to match the time frame you are focused on. Simply make sure that the Sales and COGS numbers you use for the formula cover the same period of time.

Doing the Math

So, let's put it all together with a practice example. The fictitious company, CS Appliance, had YTD Sales of $2,000,000 through the first six months, with a Cost of Goods Sold (COGS) at $1,600,000. The average month-ending inventory is $535,000, the average month-ending receivable is $80,000 and average month-ending payable of $450,000 (20% Gross Margin). But are they effectively managing their cash flow?

First, calculate the Days Inventory Outstanding using the DIO for CS Appliance.

$535,000 ÷ $1,600,000 X 180 = 60.1875 or 62 Days

Next, calculate the Days Sales Outstanding using the DSO formula, which gives a result of 7.2 days. Add these two together (60.2 + 7.2), we arrive at the Cash Cycle, which shows that on average, it takes CS Appliance 67.4 days from the moment they receive the inventory, to sell and receive payment.

Finally, we can compare the Cash Cycle to the Days Payable Outstanding to understand cash flow. The formula for understanding DPO is similar to the other two:

Days Payable Outstanding

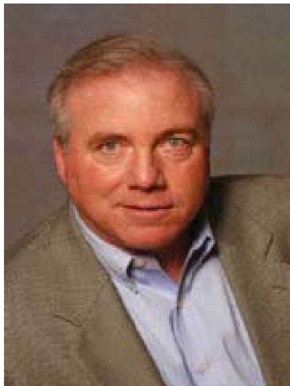
$$DPO = \left(\frac{\text{ENDING ACCOUNTS PAYABLE}}{\text{TOTAL COST OF GOODS SOLD}} \right) X \text{ DAYS}$$

$450,000 ÷ $1,600,000 X 180 = 50.625 days

When we compare the difference between our Cash Cycle (67.4 days) and our Payables (50.6 days), we find a cash conversion rate of 16.8 days. CS Appliance is paying funds out almost 17 days faster than it is converting inventory and accounts receivable to cash.

Matching Turn to Terms

Comparing your Cash Cycle to your Accounts Payable Cycle and calculating your cash conversion rate on a quarterly – or even monthly – basis can help you better understand your cash flow. By ensuring your inventory turns are matched closely to your payment terms, your cash flow is increased and your business has more liquidity.



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