Applied Financial Statement Analysis

Assignment - 10

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Define cash conversion cycle:

The cash conversion cycle (ccc) is a metric that measures the time (in days) it takes for a company to convert its investments in inventory and other resources into cash flows from sales. It reflects the efficiency with which a company manages its working capital. The ccc helps a company understanding how long each dollar invested in operations is tied up before it is converted into cash.

The formulla for the cash conversion cycle is

CCC = Days Inventory outstanding (DIO) + Days sales outstanding (DSO) - Days Payables outstanding (DPO).

Key components :-

1. Day Inventory outstanding (DIO):

The average number of days the company takes to turn its inventory into sales. A lower DIO indicates efficient inventory mangement.

$$DIO = \frac{\text{Average Inventory}}{\text{Cost of Goods Sold (COGS)}} \times 365$$

2. Days sales Outstanding (DSO):

The average number of days it takes the company to collect payment after making a sale. A lower DSO means the company is collecting payments from customers quickly

$$DSO = \frac{\text{Accounts receivable}}{\text{Total credit sales}} \times 365$$

3. Days Payables Outstanding (DPO):

The average number of days the company takes to pay its suppliers after receiving inventory. A higher DPO is generally better for cash flow as the company can hold onto its Cash longer.

$$DPO = \frac{\text{Accounts Payable}}{\text{COGS}} \times 365$$