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Use cashflow management for a more profitable business

By Jim Morphey
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Cashflow shows the amount and speed of funds flowing into and out of your business. If managed properly, understanding and managing cash flow can help improve Return on Investment (ROI). While many business owners look at sales or gross margin to measure the health of their business, cashflow management can be an even more valuable tool for profitable growth and success.

One challenge a business owner faces is shortening the cashflow cycle as much as possible, while extending accounts payable under interest-free financing terms. A shorter cash conversion cycle also improves ROI. Let's face it – a business is the owner's 401K for the future. They want the highest return possible on their investments.

A simple plan
We all know that to have a successful business, it must be managed well. Luckily, we have a few simple measures to help owners understand better cashflow management. There are two standard measures Days Inventory Outstanding (DIO) and Days Sales Outstanding (DSO).

The formulas are:

$$\text{DIO} = \left[\frac{\text{Ending inventory}}{\text{Total cost of goods sold}}\right] \text{X Days} \qquad \text{DSO} = \left[\frac{\text{Ending accounts receivable}}{\text{Total sales}}\right] \text{X Days}$$

Many business owners use 90, 180, or 360 days as the time period. A Wells Fargo CDF representative can help determine the appropriate number of days to use. The formula is always the same. Just change the number of days to match the selected time frame. Simply make sure that the numbers used for sales and Cost of Goods Sold (COGS) cover the same time period.

Doing the math
A fictitious company – CS Appliance – has year-to-date sales of $2 million through the first six months, with $1.6 million in COGS. The average month ending inventory is $535,000, the average month ending receivable is $80,000, and an average month ending payable of $450,000, a 20 percent gross margin.

Are they effectively managing their cashflow? First calculate the DIO using the above DIO formula above.

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

Next, calculate the DSO using the DSO formula. The result is 7.2 days. Add these two together (60.2 + 7.2) and we arrive at CS Appliance's cash cycle. This shows that it takes CS Appliance an average of 67.4days from the moment they receive the inventory, to sell and receive payment.

Finally, we can compare the cash cycle to the Days Payable Outstanding (DPO) to understand cashflow. The formula for understanding DPO is similar to DIO and DSO.

$$\text{DPO} = \left[\frac{\text{Ending accounts payable}}{\text{Total cost of goods sold}} \right] \text{X Days}$$

($450,000 ÷ $1,600,000) 180 = 50.625 days

When we compare the difference between CS Appliance's cash cycle of 67.4 days to its DPO of 50.6 days, we find a cash conversion rate of 16.8 days. CS Appliance is paying funds almost 17 days faster than it is converting inventory and accounts receivable to cash.

Matching Turn to Terms
Comparing a cash cycle to an accounts payable cycle and calculating your cash conversion rate on a quarterly – or even monthly – basis can help a business better understand its cashflow. By ensuring inventory turns are matched closely to payment terms, cashflow is increased and a business has more liquidity.

Jim Morphey is the vice president of corporate development for Wells Fargo Commercial Distribution Finance (CDF). Morphey has more than 40 years of management experience in consumer finance, trade credit, and most recently with domestic and international inventory financing, as well as factoring. Morphey's career has been devoted almost entirely to the domestic consumer electronic, appliance, and outdoor power industries. His background includes executive assignments in operations, credit, and relationship management at the national level with Whirlpool, Whirlpool Financial Corporation, Transamerica Distribution Finance, and senior relationship assignments at GE Capital.

Morphey received a Bachelor of Science in Management from Northern Illinois University. He was a member of the Association for Finance Professionals (AFP). He earned professional certifications from The National Association of Credit Management/Credit Research Foundation (NACM/CRF) Graduate School of Credit & Financial Management held at Dartmouth College, and also from The Finance, Credit, and International Business Association (FCIB). Morphey has published many articles on the topics of inventory management as well as cashflow. He also helped produce a six part video series on a variety of cashflow topics which may be found at www.cdf.wf.com/learningcenter. Morphey and his family reside in southwestern Michigan.

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