Answer on Question #44744 – Management - Other

Explain three factors that affect cash operating cycle

Solution

What factors affect the cash operating cycle?

1. Liquidity Vs Profitability decisions of the firm; The higher a firm retains liquid assets (cash), the shorter the operating cycle

2. **Industry norms**: eg Retail vs construction. A Construction firm will have a longer operating cycle, since they have long term projects, while the bulk of payment is received towards the end of the project. A retail business on the other hand, eg a supermarket has a short or even negative operating cycle, since there are very few credit customers, there is high turnover and can negotiate long credit period with suppliers.

3. **Management efficiency**. The less efficient the management of a firm, the longer the operating cycle and vice versa.

The cash conversion cycle (CCC) is a key measurement of small business liquidity. The cycle is in essence the length of time between cash payment for purchase of resalable goods and the collections of accounts receivable from the sale of such goods to customers; as such, it focuses on the length of time that funds are tied up in the cycle. Large business firms tend to have shorter CCC periods than do small retail businesses. The latter institutions, however, can take steps to reduce the length of their cash conversion cycles, including reducing inventories or receivables conversions. CCC length is also inversely related to organizational cash flows, and a significant positive relationship exists between CCCs and current and quick ratios.

The cycle is composed of the three main working capital components: Accounts Receivable outstanding in days (ARO), Accounts Payable outstanding in days (APO) and Inventory in days (IOD). The Cash Conversion Cycle (CCC) is equal to the time is takes to sell inventory and collect receivables less the time it takes to pay your payables, or:

CCC = IOD + ARO – APO