Cash to cash cycle explanation

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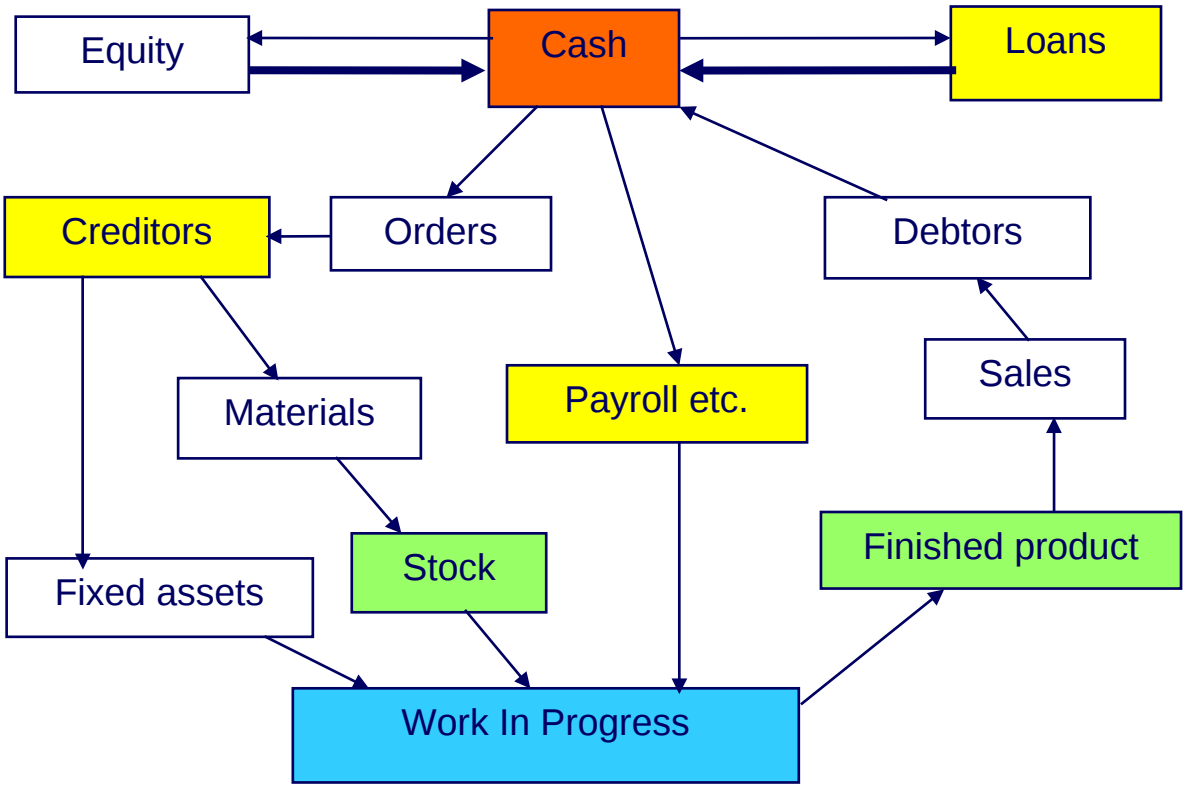

The cash to cash cycle is a demonstration of the flow of cash in a business.

At the top of the diagram, cash is injected into the business in the form of equity investment and loans.

Going anticlockwise around the cycle, the cash is then used to purchase the machinery, stock, materials and wages as well as pay overheads. Cash has gone into all these elements but no cash has yet come out.

Eventually, moving further anticlockwise around the cycle, the finished product is sold, an invoiced raised and then there is the wait until the debtor pays the sales invoice.

Eventually, the cash is returned, hopefully with a bit extra (the profit), to the pot of cash, the bank.

But was there enough cash invested by equity and loans at the beginning to cover all the cash that was held up on the way?

At the start of trading the gross profit made through making and selling may not be enough to cover the payroll and wage costs, so the cash coming back into the cash pot would be less that what was paid out. Was there enough investment at the beginning to keep putting extra cash into the business while it runs at a loss?

One way of reducing the cash requirement early on would be to work for free or partly for

free of at a reduced rate until the business moves into profit; thus subsidising the business using sweat equity.

But getting more investment in or reducing the wage bill, is not the only way to make sure there is enough cash in the business.

Leasing the fixed assets rather than buying will reduce cash tied up in fixed assets but it may be more costly in the long-term.

Getting long credit terms with your suppliers will mean that you can reduce down the amount of cash tied up in creditors. You could, if you work it very well, receive the cash on the sale before you have paid for the stock.

By good inventory control you can reduce down the need to hold excess stock and reduce down cash tied up in stock.

By working to get jobs finished and invoiced quickly you will reduce the cash tied up in work in progress and finished product.

Finally, by having a good relationship with your customers and good credit control processes or using factoring, the cash that is tied up in debtors can be reduced.

If you manage to do all the above, you will have minimised the amount of cash investment that is required, thereby reducing the financing costs through interest on investments and cash to come more quickly into the cash pot.

There is a down side to managing all the controls necessary to streamline the flow of cash and minimise investment required; it does take time and that does cost money. So, there is a balance between reducing investments required through cash management versus the cost of maintaining those controls.