The Leverage of DSO, DPO, DOI, and the CCC

When optimizing a company's cash conversion cycle (CCC), it is important to understand both the value and the cost in doing so.

First the value: when a company collects it's receivables earlier (Days Sales Outstanding, DSO), delays its payments (Days Payables Outstanding, DPO), and/or reduces its inventory (Days of Inventory, DOI), it is maximizing its free cash. The company can then use this free cash to (1) invest back into itself by purchasing operating assets, or (2) payback its stakeholders in the form of dividends, stock repurchases, and/or paying off debt (i.e., buying back its bonds, paying down its revolver, etc.).

The value of investing back into itself will earn the company's return on invested capital (ROIC), and paying back its stakeholders will earn the company's weighted average cost of capital (WACC). Both of these interest rates should be compelling enough to make any astute company eager to implement six sigma/lean practices to maximize their free cash, and thus capture this value.

Now the cost: the cost side of this equation depends on how the company facilitates the improvement of the CCC. If the company does this organically by delaying payments, changing its credit terms and/or collection policies, and/or implementing six sigma/lean practices, then the cost is only the salaries of the staff involved. Where the cost can become quickly skewed however, is where some form of financing is paid in return for the released free cash. For example, the practice of offering 2/10 net 30 payment terms costs the issuer of the invoice a staggering 36.5% annual interest rate. What seems like a reasonable 2% giveaway is actually much more costly than one would think on the surface because any fees or interest collected against the sale is leveraged against the receivable, plus must be annualized because the sales (invoice) cycle of 30 days is applied against the receivable balance which is constant throughout the year (i.e., 365 days).

$$2\% \times (30/(30\text{-}10) \times (365/30) = 36.5\%$$

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