JOURNAL OF CURRENT RESEARCH IN SCIENCE (ISSN 2322-5009)
CODEN (USA): JCRSDJ
2015, Vol. 3, No. 2, pp: 49-53
Available at www.jcrs010.com

ORIGINAL ARTICLE

REVIEW PAPER: CASH CONVERSION CYCLE AND PROFITABILITY IN COMPANIES

Maryam Talezari, Mansur Garkaz*, Jomadoordi Gorganlidavaji

Department of Accounting, Aliabad Katoul Branch, Islamic Azad University, Aliabad Katoul, Iran

***Corresponding Author Email: M-garkaz2009@yahoo.com**

Abstract
Background: Companies can influence their liquidity using different strategies on working capital management. These strategies are defined by risks and their return. Managers of working capital are divided into two groups: conservative and daring (bold). Conservative strategy in working capital management will increase liquidity power very much. To implement the conservative policy, it is tried to minimize risk of inability to pay the matured debts. In such a strategy, manager tries to keep high volume of the current assets (which their return rates are low). Therefore, companies with such a strategy have so-called liquidity risk and low return.
Purpose: the purpose of this study was to examine results of the carried out researches on cash conversion cycle and profitability in companies.
Conclusion: in general, it can be said that managers can increase their profitability and cash flow by decreasing cash conversion cycle and period of collecting receivables.

Keywords: company, cash, resource management

INTRODUCTION

From 1900 that financial management was proposed as one of management courses, its importance was obvious in companies more than before because most decisions in company are taken based on the obtained information from it. Remund Pey Nedo defines financial management as following: it is management of resources and capital expenditures, as which maximizes shareholders' wealth. Financial management is divided into more specialized fields that working capital management plays very important role in the current; it is management of current assets and liabilities of the company. To compute working capital, current liabilities are deducted from current assets (Taghavi, 2009). The current assets and liabilities must be constantly monitored, in order to: 1) ensure that items of working capital components have reached to a desired level; 2) keep potential customers; 3) keep company's liquidity power and the company is not bankrupt (Randall et al, 2010). As goal of all companies is to obtain more profits and finally, to maximize shareholders' wealth, so any decision about working capital has potential impact on company's profitability. Therefore, the purpose of this study was to examine results of the carried out researches on cash conversion cycle and profitability in companies.

Combining Results

Policies of Working Capital and Shareholders' Wealth

Which policy is optimal to manage working capital for a company that its purpose is to obtain profit? In general, it is easy to answer the question. For working capital, the optimal policy is a policy that maximizes shareholders' wealth, but in practice, implementing the policy and transforming it as liquidity ratios, current ratios and favorable net working capital is not so easy. It means that several variables (including operating environment of company) should be controlled and influenced. Therefore, when managers want to adopt some policies on company's working capital and implement specific strategies on structure of the current assets and current liabilities of the company, they will do on their taste and their judgment is subjective (Danuletiu, A.E, 2010).

Cash Flow

Producing goods requires working capital. To produce goods, companies should buy raw materials firstly, transform them and change as made goods. As a result, receivables or receivable notes will be rose by selling inventory of the made goods. Cash flow period ends by collecting demands. Since there is no cash to buy raw materials and pay workers' wages immediately, some of working capital will be provided from payables and other payable costs. Almost all companies are active permanently. Working capital is required for production processes. Turning cash begins when a company pays for raw materials and it follows until it receives requests of selling the goods. Cash flow is calculated as the following: average period that the money is as goods' inventory plus the average time to collect demands minus deadline to pay payables. To calculate the average period that inventory is as money, we divide 360 on inventory turnover ratio. (Nassiri et al, 2014). Cash flow indicates time or period that cash is spent by a company's operational processes to produce a product item. Shortening this period means that there is spent less amount of cash for a given volume of production. Shortening the average period that money is as inventory will reduce cash flow whether by shortening the average demand collection period or by prolonging deadline to pay payables. Period of cash flow is only one of factors determining the required net working capital. Even if period of cash flow or its constitutive elements remain constant, the main factor is volume of production, which determines the required capital that should be allocated to each stages of the cycle. It requires predicting sales volume for near future. The increasing importance of working capital to sustain activities of business units have caused to consider several strategies to manage working capital. By using various strategies about working capital management, profit units can affect company's liquidity. Each strategy has different risk and return. Financial managers of companies will select bold or risky strategies, or conservative or escape risk strategies, or a combination of them, by considering the conditions prevailing in company as well as according their individual and personal characters (Rahnama Roodposhti, 2010). In terms of confidence, sales, costs, payment time and other matters are obviously known, and all companies held current assets at the lowest level only. Maintaining working capital will increase cost of financing and reduce profit, rather than institute's needs. Any maintenance less than minimum required will result to delay in payment of liabilities to suppliers of materials and goods as well as lose part of sales due to lack of inventory and restrict using credit facilities. In conditions of uncertainty, the situation will be changed. In such conditions, companies have to provide minimum cash and inventory based on payments, sales and the expected time to order; they should also maintain additional amount that is called confidence saving. The level of receivables is defined through credit terms. The better credit terms, the more receivables for a certain amount of sales. Bold investment policy of companies on current assets will decrease maintaining cash and inventory. The policy will increase risk of timely payment of debt and losing customers. Bold policy will lead to maximum efficiency mostly, but it also has a high risk; while the conservative policy is contrary (Sharma & Kumar, 2011).

Optimal Management of Working Capital

Working capital management is optimal combination of working capital items, i.e current assets and liabilities, as which maximizes shareholders' wealth (Rahnama Roodposhti, 2010). In different situations, managers of profit units should consider appropriate strategies to manage their unit's working capital by considering internal and external factors and taking into account risk and return, as which lead them to increased efficiency, liquidity power, and ability to pay debt and consequently, continuing activities of profit unit. Working capital is one financing sources, especially for SMEs and developing companies. Financial managers of business units will make decisions about working capital management daily. For example, maintaining high volume of inventory will result to reduce costs, possible interruption in production cycle or commercial losses caused by shortage of products, reduce supply costs and protecting against price fluctuations. It gives appropriate commercial credit for company's sale in many different ways. Although high investments of firms to obtain trade credit reduce inventories' risk, it will reduce profitability too (Lazaridis & Tryfonidis, 2006). Investment in current assets and working capital management is one of management concerns. In one hand, it wants to maintain its market share and the acquired business among customers and suppliers, and on the other hand, increase its profitability. For this reason, management of such short-term assets and debt requires special attention because working capital management plays an important role in profitability and liquidity for companies, as well as risk and return. Creating value for stakeholders is final objective of any company, and profitability is one of main components of the objective. Maintaining liquidity is also one of the most important objectives of business units. However, the problem is that increasing firm's profits in general, does not lead to increase liquidity, and both strategic objectives are not always aligned. If increasing profit depends upon to the use liquidity, it may cause serious problems. Therefore, it must distinguish between both strategic objectives and one should not be sacrificed for other. On the one hand, if we do not consider profits, we will not be active in long-term period; and on the other hand, if we do not consider liquidity, we may face with problems related to inability to pay debts and bankruptcy (Kiaei, 2008).

Liquidity Management

Liquidity management is an important criterion to determine policies of working capital and states company's ability to prepare the required cash. Current, immediate and liquidity ratios are useful and traditional indicators of liquidity. However, they are inadequate and only based on figures of balance sheet only. They cannot provide detailed and accurate information about efficiency of working capital management. The used mathematical equations to calculate these indices contain cash and operating assets, but in perspective of cash management basis, it is irrational to take into account operational assets such as receivables and inventory of materials and goods with cash and cash equivalents. Given limitations of traditional liquidity ratios, in the current study, it is suggested that scale of continuous liquidity can be used for working capital management. Scale of continuous liquidity refers to inlet and outlet cash flows in company that is created from acquisition of raw materials, production, sale, payments and process of collecting demands. As the scale of continuous liquidity is a function of cash conversion cycle, it is better that we use scale of cash conversion cycle to assess effectiveness of working capital management than traditional proportions (Samiloglu & Demirgunes, 2008).

RESULTS

The purpose of this study was to examine results of the carried out researches on customer relationship management, satisfaction and loyalty. The carried out researches in this field are summarized in following.

Researcher	Date	Variables	Results
Sedaghati	2013	Working capital includes the average period of collecting demands, inventory turnover period, the average period of paying debt, cash conversion cycle and net operating profit	There is an inverse relationship between periods of collecting demands; it means that companies' profitability will increase by reducing period of collecting demands. There was found no significant relationship between inventory turnover periods, the average period of paying debt, cash conversion cycle and net operating profit.
Sowmehsraei et al	2013	Impact of the average period of collecting demands, inventory turnover period, the average period of paying debt and cash conversion cycle on value and operational gross profit of companies	Results of the present research studied impact of working capital management on financial performance of companies as eight hypotheses. Due to extremely poor significant, it indicates a significant inverse relationship between cash conversion cycle and its components including period of collecting demands, inventory turnover period and periods of payable deposits with companies' profitability. Managers can increase their profitability by decreasing period of collecting demands and inventory turnover period.
Hashemi & Motallebian	2013	Abnormal operating cash flows with inventory returns	Results of the hypothesis testing showed a significant negative relationship between abnormal operating cash flows with future inventory returns
Jannesari	2012	Period of receivables' turnover, payables, inventory of materials and goods and	The research results show that companies can improve their profitability by reducing period of cash cycle, as a measure of working capital

working capital management	management, and maintain its components (period of receivables' circulation, payables and inventories) at optimal level. They can create value for their shareholders. Therefore, the longer cash conversion cycle, the more need for external financing. This increases company costs, reduces income and reduces economic added value. On the other hand, the shorter the cycle, the less accumulation of resources in inventories and receivables.

In general, by considering results of the analysis, it can be said that managers can increase profitability and cash flow of their company by shortening cash conversion cycle and period of collecting receivables. The results also suggest that shortening inventory conversion period and lengthening maturities of payables will decrease profitability and cash flow of company. Short-term financial and operational activities are main issues in working capital management. Collecting receivables as quickly as possible and delaying payments to suppliers to the maximum extent possible are pillars of working capital management. It is principle of working capital based on cash conversion cycle. Cash conversion cycle is a useful method to assess a company's cash flow because it considers time dimension of liquidity and evaluates overall ability of the company in liquidity.

REFERENCES

Danuletiu A. E. Working capital management and profitability: A case of ALBA country companies. Annales Universitatis Apulensis Series Oeconomica. 2010: 12(1).

Hashemi S. A., Motallebian Chashtari M. Examining the relationship between abnormal operating cash flows with inventory returns of companies listed on Tehran Stock Exchange. Accounting and Auditing Studies, Association of Iran Accounting, scientific-extension. 2013.

Jannesari S. A. The impact of working capital management on profitability of small and medium enterprises. Journal of Audit. 2012.

Jose M. L., Lancaster C., Stevens. J. L. Corporate return and cash conversion cycle. Journal of Economics and Finance. 1996: 20, pp 33-46.

Kiaei A. Examining and explaining strategies of working capital management in companies listed on Tehran Stock Exchange. MSc thesis, Islamic Azad University, Science and Research branch. 2008.

Lazaridis I., Tryfonidis D. Relationship between working capital management and profitability of companies listed in the Athens Stock Exchange. Journal of Financial Management and Analysis. 2006: 19(1), pp 26-35.

Nasiri Y., Fallahpour M., Amsia E. The relationship between working capital management and profitability of listed companies in Tehran Stock Exchange. The First International Conference on Economics, Management, Accounting and Social Sciences, Rasht, Academic Entrepreneurs Co., Anzali Free Zone. 2014.

Rahnama Roodposhti F, Kiaei A. Examining and explaining strategies of working capital management in companies listed on Tehran Stock Exchange. Magazine of Accounting knowledge & Research. 2008: No. 13.

Randall W. S., Farris M. T. Supply chain financing: Using cash to cash variables to strengthen the supply chain. International Journal of Physical Distribution and logistics management. 2010: 39(8), pp 669-689.

Samiloglu F., Demirgones K. The effect of working capital management on firm's profitability: Evidence from Turkey. The International Journal of Applied Economics and Finance. 2008: (1), pp 44-50.

Sedaghati F. The relationship between working capital management and profitability. Quarterly of Management. 2013: No. 9.

Shabahang R. Financial management. Auditing Organization press. 2008: Vol. I & II.

Sharma A. K., Kumar S. Effect of working capital management on firm profitability: empirical evidence from India. Global Business Review. 2011: 12(1), pp 159-173.

Sowmehsaraei M. K. A., Noorbakhsh Langroodi M., Biabani Shaer M. Investigating effect of working capital management on financial performance of companies listed on Tehran Stock Exchange. Quarterly Journal of Management. 2013: No. 9.

Taghavi M. Financial management (1). Payam Noor University Press, 3rd edition. 2009.