TERMINOLOGY PRIMER

Working Capital Simulation: Managing Growth

Elements of the cash conversion cycle:

\[ DSI + DSO - DPO = \text{cash conversion cycle} \]

- **Days Sales in Inventory (DSI)** = inventory $ balance / cost of goods sold
  
  *Measures*: how much inventory is on hand at the end of the period relative to the average cost of inventory sold during the period
  
  *Example calculation*: $10 million in inventory / ($35 million / 365) = approximately 104 days

- **Days Sales Outstanding (DSO)** = Accounts Receivables $ balance / sales per day
  
  *Measures*: how quickly a company collects on payments owed by customers
  
  *Example calculation*: $2 million in receivables / ($50 million / 365) = approximately 15 days

- **Days Payables Outstanding (DPO)** = Accounts Payables $ balance / purchases (COGS) per day
  
  *Measures*: how quickly a company pays its suppliers
  
  *Example calculation*: $1.5 million in payables / ($35 million / 365) = approximately 16 days
Elements of credit policy

A firm’s credit policy generally incorporate two elements: credit period and discount terms. The credit period is the length of time buyers are given to pay for purchases. Discounts are given for early payment and usually discount terms include the discount percentage and how rapidly payment must be made for the customer to qualify for the discount.

For example: the credit terms 2/10, net 30 signify that the customer is eligible for a 2% discount if payment is made within 10 days, otherwise the customer must pay in full within 30 days.

A line of credit is an informal agreement between a bank and a borrower indicating the maximum credit the bank will extend to the borrower. The line of credit is typically committed by the lender for no more than one year at a time.